UNIT 1 SAVING AND INVESTMENT PROCESS : ROLE OF FINANCIAL SYSTEM

Structure

1.0 Objectives
1.1 Introduction
1.2 Financial System
1.3 Financial Markets
1.4 Financial Development
1.5 Measuring Financial Development
1.6 Financial Development and Economic Development
    1.6.1 Empirical Evidences on the Linkages
1.7 Financial Liberalisation and Financial Development
1.8 Let Us Sum Up
1.9 Key Words
1.10 Some Useful Books
1.11 Answers/Hints to Check Your Progress Exercises

1.0 OBJECTIVES

On completion of reading of this Unit, you will be able to:

- State the meaning and structure of the financial system,
- Explain the concepts, techniques and theories of the financial system,
- Describe the impact of financial development on economic development, and
- Explain the evolution of policies on financial development especially since the beginning of liberalisation.

1.1 INTRODUCTION

To understand the financial system, of a country in general and Indian Financial System in particular, we require first of all, a thorough knowledge of the complex inter-relationships between economic activity and financial system. We also require knowledge of the concepts, terminology, organisational aspects and institutional network. All these basic concepts have been discussed in this Unit. This will eventually equip you to understand the financial system of a country.

1.2 THE FINANCIAL SYSTEM

Let us begin to explain the term 'Financial System' itself. Financial system is a system, which facilitates the process

of capital accumulation by transferring financial resources from savers to the investors. With financial resources, the investors create physical assets, viz. land, buildings, plants and machineries.

The financial system transfers the financial resources from savers to investors in two ways:

i) By mobilising savings of numerous small investors to make them available for productive purposes.

ii) By intermediating between savers and investors to enable transfer from surplus units, that is savers, to deficit units, that is investors, who buy physical assets with those savings.

For undertaking both of these functions namely intermediation and mobilisation of savings—a large network of financial institutions exist. These institutions form the foundation of the financial system. In course of time, the financial system has expanded and strengthened financial intermediation. **Financial Intermediaries** as they are called, are institutions, which issue their own liabilities and hold as assets the liabilities of the ultimate borrowers, that is investors in physical assets, or of other intermediaries.

The Financial Intermediaries fall into three distinct categories:

i) Commercial Banks, Cooperative Banks and Non-Banking Finance Companies,

ii) Long-term investing institutions such as Industrial Development Bank of India (IDBI) and Life Insurance Corporation of India, and

iii) Special credit institutions set up by the government to provide long-term finance for particular purposes e.g. National Bank for Agricultural and Rural Development.

All these groups compete in capital market for savings and loans.

The financial system has evolved through three stages. The pioneering financial development economist, Raymond Goldsmith (1969), in his classic work has distinguished the stages in terms of scale and composition.

Stage one: The system as it evolved in Europe and North America up to the middle of nineteenth century. During this period, financial institutions accounted for low share of outstanding assets, the financial institutions were limited, commercial banks were the leading institutions and the system did not own risk-capital.

Stage two: The structure is similar to the above but the role

of government became prominent to promote financial transactions. The proliferation of government financial institutions in developing countries is particularly noteworthy in supplying risk capital.

Stage three: The system diversified its structure, instruments and borrowing-lending activity. Financial institutions came to hold assets of higher and higher degrees of risk.

1.3 THE FINANCIAL MARKETS

You know what a market means in common parlance. In economics, however, market has a wider meaning. It goes beyond geographical area within which an asset or a commodity is bought and sold. A market provides the mechanism to bring together the people who demand for and supply of assets, wherever they exist. By this definition, a financial market exists anywhere, provided there is a demander and supplier for funds or a security. However, since the instruments by which these transactions take place grew in variety and in number, a wide network of specialised financial markets have evolved. Broadly, these consist of:

i) money market, for short-term funds, and

ii) capital market, including securities market. We are excluding foreign exchange market here.

Money Market is a market for short-term funds, beginning from overnight through 90 days, 180 days to one year. The main institutions operating in this market are the commercial banks, the cooperative banks, and discount house, etc. The Central Bank of the country, namely the **Reserve Bank of India**, acts as the **lender of the last resort**.

Capital Market is a market for medium and long-term funds. It serves the needs of industries, which requires large financial resources for longer time or for investing in physical assets. The instruments traded in this market facilitate transfer of finance from savers to investor. There are a variety of debt instruments. The main institutions operating in this market are:

i) financial intermediaries, and

ii) specialised institutions created by government.

Securities Market is by far the highly organised financial market where savers and investors are brought together by what are known as **stock exchange operators** namely, brokers and jobbers. Investors are the demanders comprising the owners of all industries and factories and savers are the

providers of finance comprising households and individuals. The stock exchange brokers and jobbers act as go between. The securities traded in this market, are the shares and debentures. **Primary Securities** are issued by non-financial deficit units (i.e. the corporates) to acquire real physical assets. **Secondary Securities** are issued by financial intermediaries which issue their own secondary securities chiefly to individuals and households. The intermediaries provide several advantages to borrowers as well as lenders in this market. Due to economies of scale in lending and borrowing and by holding large volume of securities as a buffer, the intermediaries are able to endow their own secondary securities with low risk, high liquidity, and assorted package of securities.

In India, the principal intermediaries in this market are:

- Savings Institutions
- Insurance Companies
- Mutual Funds
- Commercial Banks

The Securities Markets are also further sub-divided into **Primary Market** and **Secondary Market. Primary Market** is one in which new issues of securities are made. **Secondary Market** is one in which existing (outstanding) securities are traded. The most important feature of secondary market is its 'lead' role. The prices of and yields on the securities traded on this market set the trend in primary market. More importantly, the prices of and yields on shares and debentures of corporate entities in this market act as a guide to corporate investment decisions.

Check Your Progress 1

Note : i) Space is given below each question for your answer.

ii) Check your answer(s) with those given at the end of the Unit.

1) State whether following statements are true or false:

   i) the financial system has evolved through four stages. (True/False)

   ii) medium-term loans are extended in money market. (True/False)

   iii) shares and debentures are marketed in the securities market (True/False)

2) Name the main institutions which operate in the financial market.

   ....

   ....

3) Who do transfer the financial resources into physical assets?

....

....

....

1.4 FINANCIAL DEVELOPMENT

You will now understand the process of financial development and its relationship with economic development. Financial development refers to the process of expansion of financial superstructure. Financial superstructure, according to the pioneering financial development economist, Raymond Goldsmith, comprises the entire gamut of financial institutions and financial instruments. In a sense, financial superstructure is synonymous with financial system. The main function of the financial superstructure consists of mobilisation and transfer of financial resources to economic activities that generate maximum rate of return on investment. The size of the superstructure is measured by the size of all financial assets. The growth of the superstructure is measured by the ratio of all financial assets to Gross Domestic Product (GDP). Let us recollect that GDP is the value of all the final goods produced in an economy during one financial year.

The financial superstructure has evolved in two mutually related directions:

- Financial Widening, and
- Financial Deepening

Financial Widening refers to the growth in number and size of financial institutions known as financial intermediaries.

Financial Deepening refers to growth of aggregate monetary resources (AMR) in relation to Gross National Product. AMR comprises currency with the public (C_p), demand deposits (D_2), the time deposits (T_d), other deposits with Central Bank (O_d).

Thus, $\mathbf{M_3 = AMR = C_p + D_d + T_d + O_d}$

and **Financial Deepening** $= \frac{M_3}{GDP}$

and services produced in a year within the domestic territory of a country.

$\frac{M_3}{GDP}$ is a ratio of liquid liabilities of the financial system to GDP.

Liquid liabilities are demand deposits plus interest bearing liabilities of banks and non-banking companies. In other words, liquid liabilities = M_3. Thus the ratio $\frac{M_3}{GDP}$ is a measure of financial development.

It may be noted that both financial widening and financial deepening are considered crucial to study the levels of financial development.

1.5 MEASURING FINANCIAL DEVELOPMENT

The standard measures of financial development are described below:

i) **Financial Intermediation Ratio (FIR) :-** It is the most important measure of financial development. FIR is the ratio of financial institutions' assets to all financial instruments outstanding. The FIR measures the position of financial institutions (intermediaries) in the economy's financial superstructure. It is an indicator of the degree of institutionalisation of the financial structure. A higher FIR indicates higher level of financial development. The ratio also indicates the level of financial deepening.

ii) **Financial Interrelations Ratio (FIRR) :** This ratio measures the changes in the size of financial assets relative to change in size of tangible assets. Thus, FIRR is the ratio of changes in the size of financial assets to changes intangible assets.

This ratio compares the relative size of the financial superstructure and the real infrastructure.

The data for computing these ratios are available in National Balance Sheets in the flow-of-funds accounts published by Reserve Bank of India. For the Indian financial superstructure, these ratios have been computed from historical data (1860-1977) by Raymond Goldsmith. The ratios behaved as under :

Table 1.1: Financial Development Ratio (1860-1975)

Year	FIRR	FIR	Financial Development Ratio
1860	0.637	0.15	0.49
1875	0.473	0.13	0.44
1895	0.400	0.13	0.51
1913	0.336	0.15	0.63
1920	0.25	0.18	0.14
1929	0.27	0.18	0.20
1939	0.34	0.20	0.33
1946	0.41	0.36	0.53
1950	0.45	0.27	0.33
1960	0.54	0.26	0.50
1970	0.57	0.26	0.57
1975	0.52	0.28	0.66

Source : Raymond Goldsmith (1983). *The Financial Development of India, 1860-1977:* Oxford University Press, Bombay.

Economists have pointed out a number of factors that tend to inhibit financial development. An all encompassing phenomenon which has inhibited financial development is financial repression. **Financial Repression** refers to relatively high degree of official regulation of financial markets. Repression fragments the domestic capital market thereby restricting the pace of real capital formation.

Financial repression creates financial indiscipline among the operators and works through :

i) ceilings on and differentials in interest rates,

ii) pervasive credit rationing,

iii) selective credit policies,

iv) increase in high-powered money,

v) restriction to enter into financial market, and

vi) disintermediation from the banking sector.

Check Your Progress 2

1) What is financial widening?

....

....

....

2) What does inhibit financial development?

....

....

....

3) List the standard measures of financial development.

....

....

....

1.6 FINANCIAL DEVELOPMENT AND ECONOMIC DEVELOPMENT

We have grasped the idea of financial development and its standard measures in the previous section. Let us move a step further and discuss the nature and degree of inter-relationship between financial development and economic development, because understanding of such interrelationship is relevant for formulating and understanding the financial policies of the government.

The role of finance in economic development did not form the core interest of classical economists of the nineteenth century. They held that capital accumulation indeed was the hub of economic growth and argued that savings financed such accumulation. Savings were generated from capitalists' profits and capitalists' savings were automatically turned into capital accumulation. Finance, therefore, had a passive role to play. It was not until 1911 that the active role of finance was brought to the fore. Three landmarks in financial development are worth noting.

The first is the year 1911 itself, in which the Harvard economist Joseph Schumpeter highlighted the role of financial mobilisation. Developing the innovation theory of development, he argued that innovator was the engine of growth, and availability of finance served as the oil of the engine.

The second landmark occurred in 1940 when Raymond Goldsmith provided extensive statistical evidence to the active role of finance.

The third landmark year was the year 1955. Gurley and Shaw brought forth the critical role of intermediaries in the supply of finance to real sector as these intermediaries can also generate surplus loanable funds. Their particular finding was that growth of financial intermediation tends to exceed growth of national product.

With their (Gurley and Shaw) article, there has grown a

whole literature on finance and development linkages. It is worthy to note that we do not come across any study denying the linkage. However, the linkages sought between finance and development fall into two categories: causal role, and complimentary role of financial development.

Basically speaking, the lead role is assumed by financial intermediation. Intermediaries change the ownership of finance by transferring it to productive users. This is brought about by the 'demand following' and 'supply leading' functions of the intermediaries. Under the former, diverse types of financial instruments are created in response to demand for finance by entrepreneurs. Under the latter, the intermediaries take initiatives themselves to transfer funds from surplus units to productive deficit units, viz. the industrial enterprises.

In both cases, funds flow from investment with low returns to those with high returns and the process is governed by the monetary and fiscal policies.

1.6.1 Empirical Evidence on the Linkages

Empirical studies, however, do not strongly support the active role thesis. They find complimentary, rather causal role of intermediaries. For instance, comparison of the correlation between FIR and GNP for developed and developing countries indicates that financial and economic developments are positively related to each other. In a very low-income country like Haiti, the value of FIR was 0.5 while in the United States, it ranged between 4 and 5. For a group of Asian countries, the correlation between FIR and GDP was positive. But, for several African countries, FIR did not correlate with their GDP. An extensive study by Goldsmith also failed to find a correlation between FIR and GDP. Another study too found a mixed relation between the two. Levels of financial intermediation (FIR) positively influenced economic growth in Asian countries but not in Latin American countries.

In the case of India, Mckinnon's complimentarity hypothesis was proved valid. In a comprehensive study of 80 countries including India over a thirty-year period, a strong positive correlation between alternative measures of intermediation and alternative measures of economic development was observed.

Yet, another study reported mixed results on complimentarily hypothesis. A significant reason for this was that wherever financial reforms are implemented in an inefficient regulatory environment, financial development fails to influence economic development.

Some economists have contended that there is a discernible

causality relation. Financial development leads to economic development and not the other way round.

In brief, available studies on causality hypothesis have concluded that financial development has led to economic development in developing countries across the world. They, thus, support supply leading process of financial development. This conclusion is utilised to promote the policies of financial liberalisation.

1.7 FINANCIAL LIBERALISATION AND FINANCIAL DEVELOPMENT

We have noted in Section 1.5 that financial development is retarded when the constituents of the financial superstructure do not act according to the rule of the market or are constrained by state regulations to do so. Financial repression of the financial markets is the central inhibiting force acting on financial development. This is despite the fact that overwhelming evidences exist to show that other things remaining the same, financial and economic development compliment each other. For this reason international institutions, including World Bank and the International Monetary Fund, have advocated financial liberalisation to accelerate the rate of growth in financially repressed economies.

Financial liberalisation is synonymous for financial reforms and financial deregulation. It is a process of removing distortions in financial markets which are created by unnecessary controls and restrictions. The process consists of :

i) abolition of ceilings on interest rates on deposits, credits and loans,

ii) allowing free access to financial markets, and

iii) removal of restrictions on foreign currency circulation

However, wherever liberalisation has been implemented, it has proved to be a mixed blessing. It is, therefore, essential that countries must learn from the pitfalls in the implementation of reforms in order to strengthen finance and development linkage. Unplanned removal of financial repression would be more detrimental to economic growth than the existence of financial repression. Therefore, the following points should be kept in mind in the wake of financial reforms:

i) The first and foremost lesson from financial reforms is that it should be tailored to the needs of the existing financial system and macro economic conditions of the country. A

big bang approach, in which the standard measures are suddenly thrust on the countries, should be replaced by gradualist approach. That is, the measures must be administered to the economy in doses. It is being realised that wherever graduation was adopted, reforms have made headway, e.g. India. The adverse effects of big bang were felt severely in Russia.

ii) Secondly, the reforms should be sequenced. Fiscal reforms must precede financial reforms; domestic market must be opened up before removing interest ceilings; foreign exchange rate must be liberalised before implementing free convertibility on capital account; banking operations must be monitored to be able to control the indiscriminate short term lending.

India is perhaps one developing country where the financial superstructure is highly organised, though the size is small compared to the country's requirement. The financial liberalisation in India has entered gradually and not with big bang. It is gradually removing financial repression.

Check Your Progress 3

Fill up the blanks.

1) Financial liberalisation is ....for financial reforms. (synonymous/anonymous)

2) Financial developments................... economic development. (forwards/backwards)

3) Indian financial super structure is highly .... (organised/unorganised)

1.8 LET US SUM UP

Financial system facilitates the process of capital accumulation by transferring financial resources from savers to the investors. The process of financial intermediation is accomplished by the network of financial institutions, which are of three distinct categories : (i) commercial and cooperative banks, non-banking financial companies, (ii) long-term investing institutions, (iii) special credit institutions like NABARD.

Financial intermediation is undertaken in the financial markets which consist of money market and capital market.

The size of financial development is measured by the ratio of all financial assets to GDP. Among these ratios, two are important: **Financial Intermediation Ratio (FIR)** and

Financial Interrelations Ratio (FIRR). Financial widening and financial deepening are considered crucial to study the levels of financial development.

On the issue of interrelationship between financial development and economic development, two types of views have emerged; 'demand following' and 'supply leadings'. However, available studies have indicated that financial development has led to economic development in developing countries across the world.

Financial repression inhibits the growth of financial development. The gradual reforms in the financial sector brings the desirable results. Since July 1991, India is gradually removing the financial repressions.

1.9 KEY WORDS

Financial system : Refers to a system which facilitates the process of capital accumulation by transferring resources from savers to investors.

Gross Domestic Product : The value of all the final goods and services produced in a year within the domestic territory of countries.

Financial Intermediation Ratio : $\frac{\text{Financial Institutional assests}}{\text{Outstanding all financial instruments}}$

Financial Interrelation Ratio : Ratio of financial assets to tangible assets.

Monetary Policy : Policy dealing with the supply of money and credit and interest rates, etc.

Fiscal Policy : Policy dealing with the taxes, public expenditure and public debentures.

1.10 SOME USEFUL BOOKS

Bascom, Wilbert O. (1994). *"The Economics of Financial Reform in Developing Countries"*. St. Martin's Press. Inc. New York.

Berthelmy, I.C. and Varoudakis, A. (1996). *"Economic Growth Convergence Clubs, and the Role of Financial Development"*. Oxford Economic Papers Vp. 48: 300-328.

Fry, Maxwell J. (1989), *"Financial Development: Theories and Recent Experience"*. Oxford Review of Economic Policy, Vol. 5: 13-28.

Galbis, Vicente (1977). *"Financial Intermediation and Economic Growth in Less Developed Countries: A Theoretical Approach"*. Journal of Development Studies Vol: 13 No.2: 58-72.

Goldsmith, Raymond W. (1969). *Financial Structure and Development.* Yale University Press, New Haven.

Goldsmith, Raymond W. (1983). *The Financial Development of India 1860-1977.* Oxford University Press, Bombay, Calcutta and Madras.

Gurley, John G. (1967): *"Financial Structures in Developing Economies"*. In David Krivine, ed. Fiscal and Monetary Problems in Developing Countries. New York: 99-120.

Jao, Y.C. (1976). *"Financial Deepening and Economic Growth: A Cross-Section Analysis"*. Malayan Economic Review. Vol. 21 NO. 1:47-58.

Jung, W.S. (1986). *"Financial Development and Economic Growth: International Evidence"*. Economic Development and Cultural Change. Vol. 34: No. 2: 334-346.

King, Robert and Ross Levine (1993). *"Finance and Growth: Schumpeter Might be Right"*. The Quarterly Journal of Economics. Vol. 108: No. 3: 717-737.3.

Mickinnon, Ronald I. (1991). *The Order of Economic Liberalisation. Financial Control in the Transition to a Modern Economy.* The Johns Hopkins Press, Baltimore and London.

Patrick, Hugh T. (1966). *"Financial Development and Economic Development in Underdeveloped Countries"*. Economic Development and Cultural Cahgen. Vol. 14 No.2: 174-189.

Shaw, Edward S. (1973). *Financial Deepening in Economic Development,* Oxford University Press, New York.

Sen, Sunanda (1996). *"Financial Opening and Real Financial Nexus"*. Economic and Political Weekly. April 20-27.

1.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) i) False ii) False iii) True

2) Financial intermediaries and specialised institutions created by the government.

3) Investors.

Check Your Progress 2

1) Growth in the number and size of financial institutions is known as financial widening.

2) Financial repression.

3) i) Financial Intermediation Ratio (FIR).

   ii) Financial Inter-Relations Ratio (FIRR).

Check Your Progress 3

1) Synonymous

2) Forwards

3) Organised

UNIT 2 FLOW OF FUNDS

Structure

2.0 Objectives
2.1 Introduction
2.2 Flow of Funds
    2.2.1 Meaning of Flow of Funds Accounting
    2.2.2 Uses of Flow of Funds Accounting
    2.2.3 Sources and Uses of Funds Statement for a Sector
    2.2.4 Flow of Funds Matrix for the Whole Economy
2.3 Financial Intermediation and Disintermediation
    2.3.1 Importance of Financial Intermediation
2.4 Financial Flows in Indian Economy
    2.4.1 Instrument-wise Financial Flows
    2.4.2 Sector-wise Financial Flows
2.5 Let Us Sum Up
2.6 Key Words
2.7 Some Useful Books
2.8 Answers/Hints to Check Your Progress Exercises

2.0 OBJECTIVES

After going through this unit, you will be able to:

- Know the system of flows of funds accounting,
- Appreciate the use of flow of funds accounting,
- Evaluate the significance of borrowing and lending relationship between all the sectors, and
- Describe the nature of financial flows in the Indian economy.

2.1 INTRODUCTION

We have learnt the basic concepts like financial system, financial development, etc. in the previous Unit. The economic activities and financial system are inter-related because funds flow from one sector to the other through the process of financial intermediation. Thus, the concept of flow of funds is very significant in this context. Before proceeding further let us try to know it.

Flow of funds accounting combines income statements and balance sheets of a sector of the economy to construct sector sources and uses of funds statement. We can combine these statements of all the sectors in an economy to frame the flow of funds matrix for the whole economy. The flow of funds matrix for the whole economy is an interlocking grid of sector sources and uses statements. It shows borrowing and lending relationships between all the sectors. By examining it, we can analyse who lent to whom, and who borrowed from whom.

2.2 FLOW OF FUNDS

Accounting of flow of funds is used to analyse borrowings and lendings in financial markets. It traces financial transactions by recording the payments each sector makes to other sectors and the amounts it receives from them.

2.2.1 Meaning of Flow of Funds Accounting

Flow of funds accounting is a record of payments between various sectors of the economy. This record is prepared with the help of "sources and uses of funds" statements of the various sectors.

2.2.2 Uses of Flow of Funds Accounting

Flow of funds accounting is put to different uses.

i) It is very useful in analysing what happens in various financial markets.

ii) It traces the financial flows that interact with and influence the "real" saving-investment process.

iii) It records the financial transactions underlying real saving and investments.

2.2.3 "Sources and Uses of Funds" Statement for a Sector

A "sources and uses of funds" statement for a sector is simply the integration of its income statement with its balance sheet.

A simplified income statement for any sector would look like as follows:

Table 2.1 : An Income Statement for a single Sector

Uses of Funds (on current account)	Sources of Funds (on current account)
Current Expenditure/Savings (Addition to net Worth)	Current Receipts
Total **equals**	**Total**

An income statement like the one in Table 2.1 above simply records a sector's receipts during a period of time as a source (inflows) of funds, and its current expenditure as its uses (outflows) of funds.

Current receipts would be different for different sectors of

the economy. For the Household Sector, current receipts consist mainly of wages and salaries; for the Business Sector, these would consist of sales receipts, and for the Government Sector, these would consist of tax revenues.

Likewise, the current expenditures of different sectors also differ. Saving, on the 'use' side, is defined as an excess of current receipts of a sector over its current expenditure.

Saving, hence, serves as a balancing entry in an income statement. Thus, the sum of the uses of funds equals the sum of the sources of funds.

Income statements show current receipts and expenditures over a period of time (say, during the year 2000). **A balance-sheet**, on the other hand, shows assets and liabilities at a point of time (say, on December 31,2000). A simplified balance sheet for a single sector would look like in Table 2.2

Table 2.2 : Balance Sheet for a Single Sector as on (say December 2000)

Assets	**Liabilities and Net Worth**
Financial Assets a. Money b. Others	Liabilities
Real Assets	Net Worth
Total **equals**	**Total**

As with income statements, the principal difference between the balance sheets of different sectors relates to the composition of assets and liabilities. Like income statements, balance sheets always balance; i.e., the sum of assets equals the sum of liabilities and net worth. Net worth is defined as the different between assets and liabilities.

To analyse financial trends during a year, we need data on flows over a period of time. We cannot work with stocks as listed in a balance sheet. The stocks listed in a balance sheet can be converted into flows. For this purpose, we need two balance sheets of the same sector at two different points of time; for example, Balance Sheet as on 31.12.2000 and as on 31.12.2001. By comparing them, and recording the changes that have taken place in the values of each of the items, we can convert stocks into flows.

The change (Δ) between two dates could be represented like as in Table 2.3

Table 2.3 : Sources and Uses of Funds Statement on Capital Account

Uses of Funds (on Capital Account)	**Sources of Funds** (on Capital Account)
Δ Real Assets (Investment)	Δ Net Worth (Saving)

On the **uses side**, the change in real assets refers to capital expenditure. Capital expenditures involve the purchase of **real assets**, or what is also called investment.

On the **sources side**, the change in a sector's net worth during a period is exactly the same thing as "saving on its income statement covering that time interval.

It may further be noted that the totals on the two sides, i.e. uses side and sources side, may not tally. It means that an individual unit or sector may or may not invest just equal to its current saving. If a unit or sector invests an amount equal to its current saving, it is called a **Balanced Budget Sector**. If it saves more than it invests, it is called a **Surplus Sector**. If it invests more than it saves, it is called a **Deficit Sector.**

How could a sector invest more than it saves? One way is simply to borrow enough to finance its deficit, which brings us to the other pair of balance sheet entries - liabilities and financial assets. Such changes between two Balance Sheets would look like as in Table 2.4

Table 2.4:Sources and Uses of Fund's Statement on Capital Account

Uses of Financial Funds (on Capital Account)	**Sources of Financial Funds** (on Capital Account)
Δ Financial Assets other than money (lending) Δ Money (hoarding)	Δ Liabilities (borrowing)

For a sector, we can prepare a complete statement of sources and uses of funds by piecing together Tables 2.1, 2.3 and 2.4 as done in Table 2.5 below:

Table 2.5 : Complete Sources and Uses of Fund's Statement for a Sector

Uses of Funds	**Sources of Funds**
Current Expenditures Saving (addition to NW)	Current Receipts
Δ RA (Investment) Δ FA (Lending) Δ M (Hoarding)	Δ NW (Saving) Δ L (Borrowing)
Total **Equals**	**Total**

Above the line is the income statement, below the line, the changes in the balance sheet. The 'uses of funds' must equal the 'sources of funds'.

We can now identify the sources and uses of funds for a sector as under :

i) **Sources of funds consist of :**

a) current receipts
b) any increase in a liability item (borrowing)
c) any decrease in an asset item (selling off assets, dishoarding)

ii) **Uses of funds consist of :**

a) current expenditures
b) any increase in an asset item - increased holdings of real assets (investment) or financial assets (Lending), or of money (hoarding), or
c) any decrease in a liability item (debt repayment)

iii) **For any one sector :**

Investment + lending + hoarding = saving + borrowing
So if :
Saving > investment, then lending + hoarding > borrowing
And if :
Investment > saving, then borrowing > lending + hoarding

2.2.4 Flow of Funds Matrix for the Whole Economy

We can prepare flow of funds matrix for the whole economy by piecing together uses and sources of funds statements for individual sectors. One sector's payments become another sector's receipts. When we put all these individual sector statements together, we get a flow of funds matrix for the economy as a whole. It is an interlocking grid that reveals financial relationships among all the sectors.

Assuming a total of three sectors, the flow of funds matrix would appear as follows:

Flow of Funds Matrix for the whole economy

	Sector A	Sector B	Sector C	All Sectors
Saving (ΔNW)	μ S s	u S s	u S s	u S s
Investment (ΔRA)	i	i	i	I
Borrowing (ΔL)	b	b	b	B
Lending (ΔFA)	l	l	l	L
Hoarding (ΔM)	$\Sigma^h = \Sigma$	$\Sigma^h = \Sigma$	$\Sigma^h + \Sigma$	$\Sigma^h + \Sigma$

Note : The small letters within the matrix represent the data for saving(s), investment (i), borrowing (b), lending (l), and hoarding (h) and are placed in the appropriate spaces where such data would be entered. The capital letters simply represent the aggregate sum totals for the whole economy. Thus, s + s + s = S, i + i + i = I, etc. The letters represent uses and sources of funds.

For the whole economy :

Investment + lending + hoarding = saving + borrowing
But since one sector's financial asset is another sector's liability:
Lending + hoarding = borrowing
Therefore : Investment = saving

The conclusion that savings must equal investments applies only to the entire economy taken in the aggregate, not to any single sector by itself. Any single sector may save more than it invests, or may invest more than it saves. But since savings must equal investments for the economy as a whole, it follows that for each sector that saves more than it invests, there must, somewhere, be other sectors that invest correspondingly more than they save.

Check Your Progress 1

1) What do you mean by flow of funds?

....

....

....

2) Mention the uses of flow of funds accounting.

....

....

....

3) What does the income statement of a sector indicate?

....

....

....

4) What does the balance sheet of a sector indicate?

....

....

....

5) What does the flow of funds matrix of an economy show?

....

....

....

2.3 FINANCIAL INTERMEDIATION AND DISINTERMEDIATION

The function of the financial markets is to bring surplus sectors in contact with the deficit sectors. Financial markets provide the transmission mechanism between savers-lenders and borrowers-spenders. Financial institutions mobilise the savings and channel them into the hands of borrowers who need more funds than they have on hand.

Savers stand to benefit because they earn interest or dividends on their funds. Borrowers stand to gain because they get access to money to carry out investment plans they otherwise could not finance. Without financial markets, savers would have no choice but to hoard their excess money, and borrowers would be unable to implement any investment plans except those they could finance with their own resources.

In the financial markets, ultimate lenders are typically households, although from time to time business firms and government bodies also lend substantial amounts. Ultimate borrowers are mostly business firms and governments, although households are also important borrowers as they seek consumer credit and mortgage borrowings.

The financial market in which the transaction takes place is generally named according to the nature of the securities issued by the borrowers', e.g. the government securities market, the capital bond market, the stock market, and so on.

Financial institutions that operate in the financial markets are called financial intermediaries. Some examples of financial intermediaries are commercial banks, mutual funds,

chit funds, non-banking finance companies, provident funds, etc. These act as agents, transferring funds from ultimate lenders to ultimate borrower. Financial intermediaries, in brief, intermediate between ultimate lenders and ultimate borrowers.

Financial disintermediation is the reverse process. Savers take funds out of their bank deposit accounts, or reduce the amounts they normally put in them, and invest directly in primary securities, such as stocks and bonds.

2.3.1 Importance of Financial Intermediation

Financial intermediaries play an important role in the spread and growth of the financial system, and to that extent make a substantial contribution in the process of economic growth.

i) Financial intermediaries are in a better position than individuals to diversify the risks of primary securities ownership. Because of their large size, intermediaries can diversify their portfolios and minimise the risk involved in holding any one security. They are experts at evaluating borrower's credit worthiness. They employ skilled portfolio managers and can enjoy the advantage of economies in large-scale buying and selling.

ii) Competition among financial intermediaries forces interest rates to the lowest level compatible with the intermediaries' evaluation of the risks of security ownership. These yields are lower than if the primary securities were held by individual investors, who are unable to minimise their risks as efficiently.

iii) The beneficial effect of intermediation on economic growth can also be seen from the viewpoint of risk bearing. Financial intermediaries are better able than individuals to bear the risks of lending.

Check Your Progress 2

1) What do you mean by financial intermediation?

....

....

....

2) How is financial disintermediation different from financial intermediation ?

....

....

....

3) Highlight the importance of financial intermediation in the process of economic growth.

....

....

....

2.4 FINANCIAL FLOWS IN INDIAN ECONOMY

The principal source of data relating to financial flows in the Indian economy is the Reserve Bank of India. The Reserve Bank of India prepares estimates relating to, among other, instrument-wise financial flows and sector-wise financial flows. We will make use of these data to highlight the important features of the financial flows in the Indian economy.

2.4.1 Instrument-wise Financial Flows

The data relating to instrument-wise flows of funds is summarised in Table 2.6 (Please see Table 2.6 given in the end). The total net financial flows in the Indian economy increased from Rs. 3,771 crore during 1966-67 to Rs.4,34,308 crore during 1995-96.

In terms of their quantitative importance, different financial liabilities in India can be ranked in the descending order as follows:

Table 2.5 : Instrument-wise financial flows

Rank (Descending Order)	Instrument
1	Loans and Advances
2	Currency and Deposits
3	Investments
4	Provident Fund
5	Life Fund
6	Small Savings
7	Trade Debt or Credit

Loans and advances are the principal sources of financial flows in the Indian economy. Currency and deposits with the banking system come second.

Over the years, the share of currency and bank deposits, securities of other financial institutions, and corporate

securities in the total liabilities have increased marginally. On the other hand, the share of loans and advances and Government securities has declined.

2.4.2 Sector wise Financial Flows

Sector wise matrix of financial flows in the Indian economy is presented in Table 2.7

It must be noted from the Table 2.6 that households are the principal source of funds in the Indian economy, while the banking sector is placed second followed by other financial institutions, rest of the world, Government. and the private corporate business.

Among the users of the funds, the government has been the principal agency, closely followed by the private corporate business. Banking sector and other financial institutions too have been significant users.

Over the years, the share of banking and other financial institutions in the total sources of funds has increased, and that of private corporate business, government, and households has declined.

Check Your Progress 3

1) What are the main features of instrument-wise financial flows in the Indian economy?

....

....

....

2) Mention the main features of sector-wise financial flows in the Indian economy.

....

....

....

2.5 LET US SUM UP

1) Flow of funds accounting combines sector income statements and balance sheets to construct sector sources and uses of funds statements.

2) Any one sector can save more or less than it invests, or lend more or less than it borrows. One that saves more than it invests is called a surplus sector; it may be a net lender. One that invests more than it saves is called a deficit sector; it may be a net borrower.

3) For the whole economy, however, saving must equal investment and lending plus hoarding must equal borrowing.

4) The flow of funds matrix for the whole economy is an interlocking grid of sector sources and uses statement. It shows borrowing and lending relationships between all the sectors. By examining it, we can analyse who lent to whom and who borrowed from whom.

5) Financial intermediation involves financial institutions acquiring funds from the public by issuing their own liabilities and then using the funds to buy primary securities. Disintermediation is the reverse process; savers take their funds out of financial institutions and buy the primary securities directly themselves.

6) Financial intermediation leads to lower interest rates, because financial institutions can bear the risks of primary security ownership better than individuals can. They also enjoy economies of scale and possess more skilled management skills than is available to most individuals acting on their own.

2.6 KEY WORDS

Balanced Budget Sector : A sector whose investment equals its savings.

Deficit Sector : A sector which invests more than it saves.

Financial Capital : The liquid as opposed to physical assets of a company.

Financial Instrument : Any document which is evidence of debt, transfer of which enables the seller to acquire finance.

Financial Intermediary : Any operator engaged in bringing together ultimate providers and ultimate users of finance.

Financial Ratios : Ratios between particular groups of the assets or liabilities of an enterprise and corresponding totals of assets or liabilities, or between assets or liabilities and flows like turnover or revenue.

Flow of Funds Accounting : It combines sector income statements and balance sheets to construct sector sources and uses of funds statements.

Intermediation Ratio : It is the ratio of secondary issues to primary issues.

Surplus Sector : A sector which saves more than it invests.

2.7 SOME USEFUL BOOKS

Goldsmith, R.W. (1983), *The Financial Development of India,* Oxford University Press, Delhi

Bhole, L.M. (1985), *Impact of Monetary Policy,* Himalaya Publications, Mumbai

Robinson, R.I. and Wrighsman, D. (1981), *Financial Markets,* McGraw Hill, London, pp.93-121

Reserve Bank of India, Bulletin (Various Issues): *Report on Currency and Finance* (Annual), Annual Report

Dhingra, I.C. (2001), *The Indian Economy,* Sultan Chand & Sons, New Delhi

2.8 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Flow of funds refer to income statements and balance sheet of a sector/the whole economy.

2) i) Enables to know the developments in financial market.

   ii) Aprises us with real saving investment process.

   iii) Recording the financial transaction process.

3) See Sub-section 2.2.3

4) See Sub-section 2.2.3

5) See Sub-section 2.2.4

Check Your Progress 2

1) Financial intermediation refers to a process of transferring financial resources from the savers to the investors.

2) Financial disintermediation is a reverse process of financial intermediation. Savers withdraw their bank deposits and invest directly in primary securities.

3) See Sub-section 2.3.1.

Check Your Progress 3

1) The Total net financial flows in Indian Economy has increased about 115 times during the period 1966-67 and 1995-96. In quantitative terms, loans and advances rank highest followed by currency and deposits, investments, provident fund life fund, small savings, trade debt or credit.

2) Sector-wise households are the principal sources of funds followed by the private corporate business, banking and other financial institutions are the significant users.

Table 2.6 Financial Flows–Instrument-wise

Instrument / Sector	Banking		Other Financial Institutions		Private Corporate Business		Government @		Rest of the World		Households		Total		Discrepancy
	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	(Sources-Uses)
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
FINANCIAL FLOWS : 1995-96**															
1. Currency of Deposits	76,825	1,416	12,494	8,999	2,887	12,588	7,674	3,968	255	3,683	—	69,718	1,00,135	1,00,372	-237
2. Investments	2,765	34,835	9,338	56,482	39,574	1,230	46,858	1,078	-10,001	16,283	—	9,546	88,534	1,19,454	-30,920
a. Central and State Governments Securities	—	38,090	—	40,648	—	-442	46,441	—	—	9	—	28	46,441	78,333	-31892
b. Other Government Securities	—	-1,192	—	-1,699	—	—	417	—	—	—	—	581	417	-2,310	2,727
c. Corporate Securities	—	466	—	16,342	39,574	—	—	886	—	16,274	—	5,083	39,574	39,051	523
d. Bank Securities	2,765	—	—	3,055	—	2,39	—	-467	—	—	—	112	2,765	2,939	-174
e. Other Financial Institutions Securities of which	—	-1,851	9,338	—	—	-457	—	726	—	—	—	3,742	9,338	2,160	7,178
i) Mutual Funds (including units of UTI)	—	—	-1,785	—	—	—	—	—	—	—	—	606	-1,785	606	-2,391
f. Foreign Securities	—	-625	—	96	—	389	—	—	-10,001	—	—	—	-10,001	-140	-9,861
g. Others	—	-53	—	1,960	—	1,501	—	-67	—	—	—	—	—	-579	579
3. Loans and Advances	9,621	51,020	32,206	66,256	85,488	26,839	11,282	9,301	45	-3,757	25,466	—	1,64,108	1,49,659	14,449
4. Small Savings	—	—	—	38	—	—	9,187	—	—	—	—	9,149	9,187	9,187	—
5. Life Fund	—	—	12,768	—	—	—	1,70	—	—	44	—	13,894	13,938	13,938	—
6. Provident Fund	—	—	13,498	—	—	8,794	—	—	—	—	—	22,292	22,292	22,292	—
7. Compulsory Deposits	-7	—	—	—	—	—	—	—	—	—	—	-7	-7	-7	—
8. Trade Debt or Credit	—	—	534	—	-140	—	388	-501	—	—	—	394	782	-107	889
9. Foreign claims nor elsewhere classified	—	-5,308	—	—	—	—	—	509	1,740	-5,895	—	—	1,740	-10,694	12,434
10. Other Items nor elsewhere classified	-13	40,595	9,087	6,422	18,850	609	5,675	819	—	—	—	—	33,599	48,445	-14,846
TOTAL	**89,191**	**1,22,558**	**89,925**	**1,38,197**	**1,46,659**	**41,266**	**91,028**	**15,174**	**-7,961**	**10,358**	**25,466**	**1,24,987**	**4,34,308**	**4,52,539**	**-18,231**

@ Excludes Local Authorities except Port Trusts.

** Tentative Estimates.

Source : RBI : Report on Currency and Finance

Table-2.7: FINANCIAL FLOWS – SECTOR-WISE

Sector/Financial Transactions with other sectors	Banking		Other Financial Institutions		Private Corporate Business		Government @		Rest of the World		House-holds		Total	
	Source	uses	Source	uses	Source	uses	Source	uses	Source	uses	Source	uses	Source	uses
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
FINANCIAL FLOWS 1995-96**														
1. Banking	–	–	11,909	7,091	54,694	4,450	30,823	4,290	10,001	-2,006	22,642	56,615	1,10,067	70.380
2. Other Financial Institutions	11,274	11,337	–	–	45,673	-457	8,384	2,344	-9	5,128	2,207	42,197	67,529	47.875
3. Private Corporate Business	2,156	22,082	-754	62,736	–	–	–	2,319	–	11.978	342	5,976	1,745	1.05,091
4. Government	7,587	39,959	3,304	48,912	7,372	7,935	–	–	324	1,169	275	20,198	18,862	1,18.173
5. Rest of the World	4,850	-5,933	11,990	4,226	4,549	389	12	97	–	–	–	–	21,401	1.221
6. Households	56,615	22,642	42,197	2,207	5,976	342	20,198	275	–	–	–	–	1,24.986	25.466
7. Sector not elsewhere classified	6,709	45,145	21,279	13,025	28,395	28,607	31,610	5,849	1,725	5,851	–	–	1,24,986	
Total	**89,191**	**1,22,558**	**89,925**	**1,38,197**	**1,46,659**	**41,266**	**91,028**	**15,174**	**7,961**	**10,358**	**25,466**	**1,24,986**	**4,34,308**	**4,52,539**
(Sources – Uses) $		-33,367		-48,272		1,05,393		75,854		18,319		99.520		-18,231

@ Excludes Local Authorities except Port Trusts.

$ Financial Surplus (-) : Financial Deficit (+)

** Tentative Estimates.

Source : RBI : Report on Currency and Finance

UNIT 3 DETERMINANTS OF INTEREST RATES

Structure

3.0 Objectives
3.1 Introduction
3.2 Pure Interest and Gross Interest Rates
3.3 Bond Price and Yield to Maturity
3.4 The Term Structure of Interest Rates
3.5 Factors Affecting Market Interest Rates
3.6 Effects of Changes in Interest Rates
3.7 Let Us Sum Up
3.8 Key Words
3.9 Some Useful Books
3.10 Answers/Hints to Check Your Progress Exercises

3.0 OBJECTIVES

After studying this Unit, you will be able to:

- Explain the concepts, like pure and gross interest rates, bond price etc.,
- Summarise the important theories of term structure of interest rates,
- Identify the factors influencing market interest rates, and
- Describe the effects of changes in interest rates.

3.1 INTRODUCTION

Borrowing and lending in the financial market depend to a significant extent on the rate of interest. In economics, interest is a payment for the services of capital. It represents a return on capital. In other words, interest is the price of hiring capital. Capital, as a factor of production, takes the form of machinery, equipment or any other physical assets used in production of goods. On the other hand, funds must be made available to the entrepreneurs for buying these physical assets. Purchase of capital assets is called investment and funds made available for the purchase of such capital assets is called financial capital. Some persons have to supply this financial capital to the entrepreneurs who would use it for investment in real capital assets. The payment to those who supply financial capital for its use is called the **market rate of interest.** This is expressed as a percentage of sums of funds borrowed. On the other hand, the entrepreneur who buys capital equipment and uses it in the process of production gets addition to his revenue, which is called **return on capital.** The return on capital is the addition to production which increases his revenue.

3.2 PURE INTEREST AND GROSS INTEREST RATES

According to Prof. Meyers, interest is the price paid for the use of loanable funds. Different rates of interest are charged for the same sum of loan for the same period because of the fact that some loans involve more risk, more inconvenience and more incidental work. Thus interest is of two types : *pure interest* and *gross interest.* The **pure interest** is the payment for the use of money as capital when there is neither inconvenience, risk nor any other management problem.

Whereas, ***gross interest*** is the gross payment which the lender gets from the borrower. It includes not only net interest but also payment for other elements, which have been outlined below.

Elements of Gross interest

i) **Payment for risk :** Every loan, if not secured fully, involves risk of non- payment due to the inability or unwillingness of the borrower to pay back the debt. The lender charges something extra for taking such risk.

ii) **Payment for inconvenience :** The moneylender may add extra charges for the inconvenience caused to him. The greater the inconvenience involved, the higher will be such charge and consequently the gross interest. For instance, the borrower may repay at a very inconvenient time to the lender or the borrower may invest the capital for a period longer than the one for which loan has been given.

iii) **Payment for management :** The lender expects to be compensated for the additional work he has to do in connection with lending e.g., the form of keeping accounts, sending notices and reminders and other incidental work.

iv) **Payment for exclusive use of money, i.e. pure interest:** It is the payment for the use of money which is in addition to payments for the above-mentioned risks, inconvenience and management.

In short, gross interest is the total payment which the lender gets from the borrower, whereas, net interest is just one part of gross interest which is paid exclusively for the use of capital. According to Keynes, interest is purely a monetary phenomenon and its rate is determined by the monetary forces of demand and supply. Interest is the reward for capital and is the payment made to the supplier of capital for the use of this factor in the process of production.

3.3 BOND PRICE AND YIELD TO MATURITY

Price of a bond moves inversely to the yield to maturity. Therefore, the best approach to predict the bond price is to first know its yield of maturity. The yields of maturity of all bonds are dependent upon market interest rate, which fluctuates frequently. These fluctuations arise from factors which are internal as well as external to the firm using the funds.

1) **Internal Factors :** The probability that the investor in bond might suffer from default or bankruptcy of the issuer is called **default risk**. Default risk is that portion of an investment's total risk that result from changes in the financial solvency of the investment. For example, when a company that issues security moves close to bankruptcy, this change in the firm's financial solvency is reflected in the market price of its securities. The variability of return that investor experiences as a result of changes in the credit worthiness of a firm that issues the investment securities is their **default risk**. Default risk can be further divided into: (i) business risk, and (ii) financial risk.

   i) **Business risk :** It refers to the variability of operating incomes or earning before interest and taxes. It is influenced by demand variability, price variability and operating leverage.

   ii) **Financial Risk :** It represents the risk arising from the use of debt capital. If the firm depends heavily on debt capital, it will have high degree of financial risk exposure.

2) **External Factors :** These factors affect bonds simultaneously. Change in the supply and demand for credit, changes in the macroeconomic environment (also called **market risk**) are factors external to the individual corporations, which affect their bond yield and prices. These factors determine the level and structure of market interest rates, and thus, bond prices.

i) **Purchasing Power Risk**

An increase in the amount of currency in circulation may result in sharp and sudden fall in its value. Purchasing power risk denotes the fact that an investor's money may lose its purchasing power because of inflation. To understand purchasing power, first, we will see how inflation can be measured. Economists measure the rate of inflation by using **Price Index**, which is prepared by government agencies. Such Price Index measures the cost of a representative basket of consumer goods, which include food, clothing, housing and health care products, which are bought by average urban households. Prices of the goods change from

month to month. The amount of that change is stated as a percentage and thus the resultant figure is that of inflation. In other words it is the *difference between the price index of a commodity in two months divided by the price index in the previous month.* Thus, we may call the inflation rate of the month, which is converted into annual inflation. For example if inflation is 1% then annual inflation will be $(1+1.0\%\text{ per month})^{12} - (1.01)^{12}$ 1.1268 + 12.68%

The goods which have strong demand will experience faster rate of inflation than the goods that are not in strong demand.

ii) **Real Return/Nominal Return**

After inflation is measured, it should be compared to investment return. An investment's nominal rate of return is money rates of return, that is, they are not adjusted for the effect of inflation. Take up a numerical problem to understand. We assume that a saving deposit earns a nominal interest rate of 5% during one-year period. Thus, if Rs. 100 are deposited, it would grow to 100 (1 + 0.05) = Rs 105 in a year. If we also assume that rate of inflation is 5% then the real value (in term of current purchasing power) of Rs. 100 saving at end of the year is still 100 after we divide the nominal rate by the inflation rate to get the real rate

100 (1.0 + 0.05/1.0 + 0.05) = Rs. 100

In this case, the nominal rate of return and inflation rate are same. A wise investor should compare the inflation rate with the nominal rate of return from different investment to see if the investment's real rate of return is positive or negative.

Investors should focus on real returns so as

i) to avoid being fooled by the money illusion fallacy, and

ii) to detect those investments that will maximize their purchasing power.

The saving's purchasing power will not increase even though there will 5 percent more rupees in it.

iii) **Market Risk**

Market ups and downs are usually measured by using a Security Market Index. When a security index rises fairly consistently for a period of time, this upward trend is called a **Bull Market**. The bull market ends when the market index reaches a peak and starts a downward trend. The period of time during which the market declines is called **Bear Market**. Market risk arises from this variability in market return, which results from the alternating bull and

bear market forces. The main element that causes the stock market to rise 'bullisthly' and then fall 'bearishly' again and again, is the fact that the nation's economy follows a cycle of recessions and expansions.

Market yield to maturity are determined by many things. The most basic determinant of interest rate is what economists call the real rate of interest, or the rate at which capital grows in the physical sense. In addition to the real rate of interest, market interest rate are also affected by various risk premiums which investors may demand. In order to undertake risky investments, lenders may requisite one or more risk premiums to be paid over and above the real rate of interest to induce them to lend their funds when the risk of loss exist.

Since the interest rates and loans are typically in nominal money quantities, rather than real physical quantities, the nominal interest rate must contain an allowance for the rate of price changes so that lender's wealth is not be croded away by inflation.

Level of interest rate is determined by

Nominal or market interest rate = real rate of interest + various possible risk premium + expected rate of return

Although, the rising rates of inflation push up the interest rate, but sometimes, changes in interest rates are not related to inflationary factors but, are result of various risk premiums, changes in supply of and demand for loanable funds. During a period of economic expansion, the unemployment rate falls, business activity quickens and business needs more money finance for purchase of machinery and to build bigger plants. This results into higher interest rate. In contrast, during slowdowns and recession, unemployment increases, manufacturing activity slows and demand for credit decreases. This results into fall in interest rate, if all other factors are constant.

The combined effect of changes in inflationary expectation and changing credit market conditions causes the level of market yield to vary over a wide range from year to year. Any bond issuer usually has, on any given day, different yield to maturity on its various bond issues, which will differ in terms of maturity. For a given bond issue, the structure of yield for bonds vary with different terms to maturity, but no other difference is called term structure of interest rate.

When two bonds are alike or nearly so in all respects except time to maturity, they usually set at different yield because of the difference in their maturities. The relationship between

yield and maturity is known as **term structure of interest rate**. A plot of this relationship is known as **yield curve**

The level of inflationary expectations and the phase of business cycle are two of the main factors, usually affecting interest rates. But various kinds of risk premiums, which rise and fall, can also have an important effect on market interest rates.

iv) **Yield Spread**

A yield spread is the *difference between the promised yields on any two bond issues or classes of bonds.* Yield spread may also be called risk premiums because they measure the additional yield that risky bonds pay to induce investors to buy more-risky bonds, rather than less risky bonds. Yield spread, other than spreads between different maturities are caused primarily by difference in risk and taxability, but they are also influenced by anything that affects the supply of and demand for various kinds of bonds.

Risk premiums are higher when economic conditions are not favourable. During recession, fear of job loss and risk aversion are higher. Therefore, most investors demand large risk premiums to induce them to buy risky bonds.

Secondly, the corporation which issues bonds, typically experiences reduced sales and profits during recession. Since the issuers are more subject to bankruptcy during recession, investors require larger risk premiums.

Thirdly, the daily sale and purchase of bonds by bankers and investment managers have a substantial impact on yield spread. Most of these financial experts scrutinize the political developments, which have economic financial implications. When a country is involved in a war, it usually spends more on war. Most governments finance their deficits by printing new money which results into inflation which exerts harmful effects upon the economy of the country.

Check Your Progress 1

1) What is the difference between Gross Interest and Pure Interest?

....

....

....

2) State whether following statements are true or false?

   i) There is a direct relationship between price of a bond and its yield to its maturity. (T/F)

   ii) Risk arising from the use of debt capital is known as financial risk. (T/F)

iii) Changes in macro-economic environment does not affect the bond yield and prices. (T/F)

3) How is the rate of inflation measured?

....

....

....

4) What do you understand by the term 'Yield Spread'?

....

....

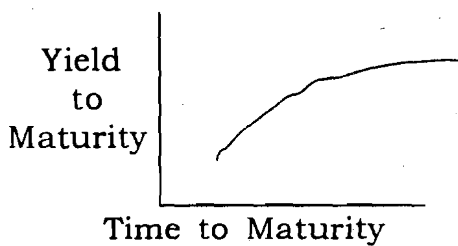
....

3.4 THE TERM STRUCTURE OF INTEREST RATES

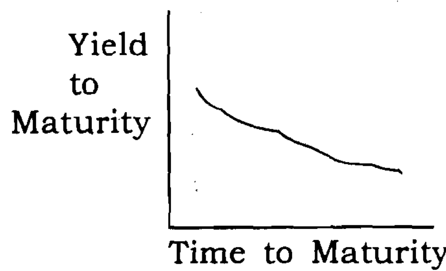
In addition to changes in the level of interest rate, which arise due to changes in the rate of inflation, unusual risk premiums, changing credit conditions, there are changes, which are termed as the 'term structure of interest rate'. For a given bond issuer, the structure of yield for bonds with different terms of maturity is called the 'term structure of interest rates'. 'The term structure of interest rate', or 'yield curve', as it is called, may be defined as the *relationship between yields and maturities of bonds in given default risk classes.* The relationship is usually presented graphically as 'Yield Curve'. The yield curve changes a little everyday and there are different yield curves for each class of bonds. The yield curve for the riskier classes of bonds are at a higher level than the yield curve for less risky bonds. The difference in levels is due to the difference in risk premium. The yield curves for risker bonds are not so stable.

There are two types of yield curves as presented in figure (A) and (B). On the vertical axis in both the figures, 'yield to maturity from a security is drawn, whereas, on the horizontal axis time to maturity is drawn. There is a positive relationship between the yield to maturity and the time to maturity, if yield to maturity increases as time to maturity increases. This positive relationship between yield to maturity and time to maturity is shown in figure (A), and the yield curve obtained from this relationship is called as **'normal' yield curve'**. The 'normal yield curve' is called so, because it is more common.

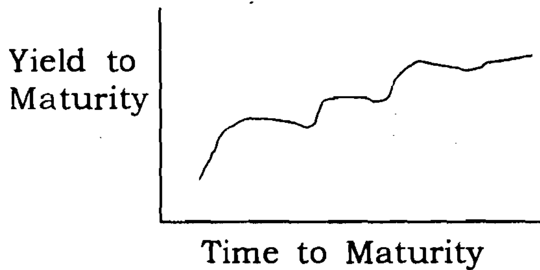
However, sometimes, the relationship between the yield to maturity and time to maturity is not positive. This results in a downward sloping yield curve (as shown in figure B). This downward sloping yield curve is known as **'inverted yield curve'**.



(A)
Normal Yield Curve



(B)
Inverted Yield Curve



(C)
Humped Yield Curve

The above-mentioned yield curves are simplified versions of yield curves. In the practical world however, the shape of yield curves is much more complex and sometimes it takes the shape of 'humped curve' [as shown in figure (C)].

There are three theories about how the shape of yield curve is determined.

1) The Liquidity Preference Theory

According to Liquidity Preference Theory, lenders prefer short-term securities over long term securities, unless the yield on the longer-term securities are high enough to compensate for the greater interest rate risk. Risk is related to variability of return or dispersion of market value. So interest rate risk increases with term to maturity of a bond. The long-term bonds have more interest rate risk than short-term bonds because of their long duration and because their interest elasticity is larger. As a result, the prices of long-term bonds fluctuate more than the prices of short-term bonds. The large price fluctuations are the basis of liquidity premium hypothesis.

Unlike lenders, borrowers show a preference for long-term securities. They (borrowers) will borrow on a relatively short-term securities only if these are available at smaller interest rates.

Thus, generally, lenders are averse to long-term securities (because of the higher risk involved), and borrowers are averse to short-term securities. These aversions on the part of lenders and borrowers influence the term structure of

interest rates. However, the term structure on interest rates is likely to vary over time, as the degree of these aversions varies. Thus, the degree of these risk aversions influences the shape of yield curve also. With an increase in the risk aversion on either or both the parties, yield curve moves upward and vice-versa. However, Cooper and Fraser (1990) noticed that, liquidity preference, by itself, couldn't account for a downward sloping yield curve. Maturity preferences by the borrowers and lenders, their expectation regarding future yields etc. are other explanatory factors. However, there are other theories, which have attempted to identify these factors. These theories are discussed as follows.

2) **Expectations Theory**

The Expectation theory hypothesises that investors' expectation alone shape the yield curve. This theory assumes that the yield on a long-term bond is an average of the short-term yields that are expected to prevail over the life of the long-term bond. Its validity rests on the assumption that investors are indifferent to any variation in risks associated with different maturities. They consider long term and short-term bonds to be perfect substitutes for one another, and, therefore, move freely from one maturity to another always looking for highest expected return. This implies that when all investors expect the rates to –

i) rise, the yield curve would slope upward

ii) remain unchanged, the yield would be horizontal or

iii) fall, the yield curve would slope downward.

3) **Market Segmentation Theory**

According to market segmentation theory, interest rates for various maturities are determined by demand and supply conditions in the relevant segments of the market. Investors are not indifferent to difference in maturities. Instead they have definite maturity preferences, which are based largely on the nature of their business.

For example, using the simple arithmetic average if 1st year rate is 10% and it is expected to be 11% next year, then the rate on two-year bond will be approximately 10.5%

$10+11/2 = 10.5$

If we assume forward interest rate that we expect to exist in 3 year ahead is 15% then bond rate will be approximately 12%

$(10 + 11 + 15)/3 = 12\%$

The interest rates are generally referred to as spot and forward rates. Forward rate refers to yield to maturity for

bond which is expected to exist in future: Whereas, spot rate refers to the interest rate for bond, which currently exists and is being currently bought and sold. Forward rates are implicit. These rates cannot be observed, whereas, spot rates can be observed.

This theory is also referred to as **'hedging theory'**. The implication is that investors' decisions are typically affected by the particular pattern of their liabilities. Given the maturity of investors' liabilities, he or she can hedge against capital loss in the bond market by synchronizing asset with liability maturities. Thus, each investor remains confined to some maturity segment, which corresponds to his or her liability maturities.

Some bond portfolio managers attempt to increase their portfolios' yield by undertaking a bond investment strategy called 'riding the yield curve'. This strategy may be undertaken whenever the yield curve is upward sloping (that is the long term rates are higher than the short term rates) regardless of whether the yield curve is smooth or kinky.

Riding the yield curve is a buy and hold strategy, in which the bond investor purchases an intermediate or long term bond when the yield curve is sloping upward and is expected to maintain this slope and level. The purchased bond is simply held in order to obtain capital gains that occurs as the bond move closer to the maturity date and thus rides down the yield curve. That is in addition to the coupon rate. Bond investor earns capital gains. Of course, danger in this strategy is that the level of interest rates may rise or that the short-term end of the yield curve may wing upward.

A compilation of all these theories furnishes the best description of the elements of determining the 'term structure of interest rate'.

Check Your Progress 2

1) What do you mean by 'term structure of interest rates'?

....

....

....

2) State whether following statement are true or false:

   i) According to Liquidity Preference Theory, interest rate increases with term to maturity of a bond. (T/F)

   ii) According to Expectation Theory of Interest, yield on a long-term bond is an average of the short-term yield, expected to prevail over the life of the long-term bond. (T/F)

iii) The yield curve slopes upward in the event of falling yield rates. (T/F)

iv) Market Segmentation Theory of interest stipulates that interest rates for various maturities are determined by demand and supply conditions in the various segments of the market. (T/F)

3.5 FACTORS AFFECTING MARKET INTEREST RATES

There are many interest rates in the market and they do not always move in the same direction or to the same extent. Therefore, it is sometimes useful to select one rate to represent the short-term market. It is commonly believed that four factors are dominant in determining interest rate levels. These are state of economy, monetary policy, inflation expectations and federal budget.

Three other factors that can be important are:

i) Saving by individuals,

ii) International capital flows, and

iii) Amount of premium required by investors to compensate for interest rate risk.

1) **Economic Conditions**

Interest rates have a tendency to move up and down with changes in the volume of business activities. In period of rapid economic growth, business firms require large amount of capital to finance increased requirements of in working capital and fixed asset. The business demand for borrowed funds, combined with increase in consumer borrowing put upward pressure on interest rates.

2) **Monetary Policy**

Monetary policy refers to the policy measures adopted by the Central Bank of the country such as changes in rate of interest (i.e, change in cost of credit) and the availability of credit. The policy regarding the growth of money supply also comes under the purview of monetary policy. Changes in bank rate, open market operations, cash reserve ratio of banks, selective credit controls are the various instruments of monetary policy.

i) **Bank Rate**

Bank rate is the rate at which the central bank of a country provides loans to the commercial banks. Bank rate is also called the discount rate because in the earlier days, the

central bank used to provide finance to the commercial banks by rediscounting their bills of exchange.

Through change in the bank rate, the Central Bank can influence the creation of credit by the commercial banks. When the Central Bank raises the cost of borrowing, the bank rate would rise. When bank rate is raised, the commercial banks also raise their lending rates. When the rate of interest charged by commercial banks are high, businessmen are discouraged to borrow more. This would tend to contract bank credit and hence would result in reduced aggregate demand for money. This would reduce prices and check inflation or rising prices. On the other hand, by lowering the bank rate, the Reserve Bank encourages or induces the commercial bank to borrow more funds from it. This enhances their capacity to make more credit available to the businessmen.

ii) **Open Market Operations**

The term 'open market operation' means the purchase and sale of securities by the Central Bank of the country. The sale of securities by the central bank leads to contraction of credit and purchase of securities that leads to credit expansion. When the economy is in the grip of depression, purchase of securities by central bank from the open market is called for. The central bank will pay the price of the securities to the sellers, which are generally the commercial banks. As a result of this, the quantity of cash at the disposal of commercial banks will go up and they will be in a position to expand credit to the businessmen. With this, the aggregate demand will increase which will help to cure depression. On the other hand, during inflation the central bank sells the securities and thereby contracts money supply.

iii) **Cash Reserve Ratio (CRR)**

A cash reserve is the fraction of total deposits of the banks, which is required to keep as deposit with RBI. When RBI wants to contract credit or lending by banks, it raises the CRR. On the other hand, when it wants to increase the availability of credit, it lowers the CRR.

iv) **Supply of Money**

One of the primary objectives is to achieve stable economic growth with a low rate of inflation. Generally the faster the legal reserves are allowed to grow, the greater the volume of lending, the faster the growth rate of money supply. If the supply of money grows faster than the needs of the economy for a considerable period of time, nominal interest rates will rise due to an increase in the rate of inflation

3) **Expected rate of Inflation**

Purchasing power risk arises from unanticipated inflation. It is the risk that the rate of inflation will be greater than the investor expected when the investment was made causing the real rate of return to be lower than expected. Because of these risks, market interest rates and other required returns include an inflation premium.

4) **Government Deficit**

Increase in government securities, unless offset by decreases in other borrowing means an increase in the total demand for loanable funds. There is a positive correlation between the amount of government deficit and the money supply.

3.6 EFFECT OF CHANGES IN INTEREST RATES

The basic argument of interest rate policy is that a rise in the interest rate raises the cost of credit and thus discourages investment as well as consumption financed with loans. On the other hand, lowering of the rate of interest cheapens the cost of credit and thus encourages investment expenditure as well as consumption expenditure. Hence, the interest rate policy can be used as a contra cyclical measure.

A change in the short-term rate of interest can be brought about by changing the bank rate, the rate at which the Central Bank of a country discounts the first rate short-term bills of exchange. It is assumed that a change in the bank rate directly influences the rate of interest charged by the commercial banks on their advances, as well as the other short-term interest rates, such as those charged for money at call, bill discounted, hire purchase finance etc. However, the short-term rate of interest is relevant to investment in inventories. A change in this rate is not likely to influence it significantly, as interest cost constitutes only a small part of the total cost. Similarly, it may not affect the consumption facilitated by purchase, provident fund contributions and insurance premium.

A change in the short-term rate of interest can effectively change the value of credit taking some factors into consideration. This can be explained by an example of increasing short-term rate of interest with a view to control inflationary situation. It will give rise to following difficulties:

1) It will add to the balance of payment difficulties as current account by increasing the cost of short term borrowing from abroad.

2) It will increase the cost of serving the national debt.

3) It may also tend to pull up the long term rate of interest as people may begin to expect rise in the long term rate of interest, and thus, they may begin to sell long- term securities in consequence of which their prices will fall and long-term rate of interest yielded by them will rise.

Check Your Progress 3

1) What is bank rate?

....

....

....

2) Why are the open market operations resorted by the Central Bank?

....

....

....

3) What type of relationship exists between amount of Government deficit and money supply?

....

....

....

....

4) How does the rate of interest influence the consumption and investment?

....

....

....

3.7 LET US SUM UP

Borrowing and lending in the financial market, to a significant extent, depends on the rate of interest. There are four elements of gross interest: payments for risk, payment for inconvenience, payment for management, payment for exclusive use of money. The fourth component i.e. the payment for the use of money is known as **Pure Interest**.

Price of a bond moves inversely to the yield to maturity. The yield of maturity of all bonds depend upon interest rate which fluctuate frequently. Fluctuations in the bond interest rates are caused by the internal factors namely, default risks, business risks and financial risks, and external factors i.e. purchasing power risk and market risks. Three theories have been promoted to explain how the shape of yield curve

is determined. These are: the Liquidity Preference Theory, Expectation Theory and Market Segmentation Theory.

These theories have furnished the description of the elements, which determine the term structure of interest rate. Many interest rates are found in the market and they do not necessarily move in the same direction. The reasons behind many interest rates in the market are economic condition, monetary policy, inflation expectation and federal budget.

Interest rate significantly influences the investment and consumption. Rise in the interest rate raises the cost of credit and discourages the investment expenditure, as well as consumption expenditure. On the other side, lowering of interest rate reduces the cost of credit, and thus, encourages the investment and consumption expenditure.

3.8 KEY WORDS

Bear Market : A market in which prices of shares and commodities are decreasing.

Boom : Refers to a period of expansion of business activity. A boom reaches a peak when the economy has been working at a full capacity.

Bond : A security issued by a Government, Government agency, or a private company as a means of raising money.

Bull : A person who expects prices, especially of shares and commodities, to rise.

Bull Market : A market in which prices are rising enabling bulls to operate profitably.

Depression (Slum) : The stage of trade cycle characterising decreasing prices, output and employment and thus, under-utilisation of all factors of production.

Financial Capital : Funds made available for purchase of capital assets is called financial capital.

Inflation : Inflation refers to a tendency of persistent rise in prices over a period of time.

Yield : Yield measures the annual income from an investment against its current

market price. Yield falls when prices rise.

Yield Curve : Graph showing the return on fixed interest securities according to their maturity.

3.9 SOME USEFUL BOOKS

Hendrik, S. Houthakker & Peter, J. Williamson (1996): *The Economics of Financial Markets*, Oxford University Press, Chapter 6, Page 141-167.

Bhole, L.M (1992): *Financial Institutions and Markets*, Tata McGraw Hill Publications, New Delhi, Chapter 22 Page 447-464.

Cooper, S. & Fraser, D.R. (1990): *The Financial Market Place*, IIIrd Edition, Westley Publishing Company, Massachuales, New York, Chapter 7, Page 156-182.

3.10 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Gross interest is a wider term. Pure interest is a part of gross interest which refers to the payment made for the use of capital. Gross payment is the total payment the lender gets from the borrower.
2) (i) False (ii) True (iii) False
3) The inflation is measured by the Price Index prepared by the Government agencies.
4) See Section 3.4

Check Your Progress 2

1) 'Term structure of interest rates' refers to the structure of yield for bonds with different terms of maturity.
2) (i) True (ii) True (iii) False (iv) True

Check Your Progress 3

1) The rate at which the Central Bank of a country provides loans to the Commercial Banks.
2) As a measure to cure the depression and inflation.
3) Direct.
4) The higher interest rate raises the cost of credit and thus, discourages investment as well as consumption. On the other hand, lowering of the interest rate cheapens the credit and thus, increases the investment expenditure.

UNIT 4 BUDGETARY POLICY AND INDIAN FINANCIAL SYSTEM

Structure

4.0 Objectives
4.1 Introduction
4.2 Indian Fiscal Policy
  4.2.1 Budgetary Policy
  4.2.2 Budgetary System
4.3 Indian Financial System
4.4 Impact of Budgetary Policy on Financial System
  4.4.1 Role of Budgetary Policy in the Growth of Financial Institutions
    4.4.1.1 Impact of Budgetary Policy on Banks
  4.4.2 Budgetary Policy and Financial Markets
  4.4.3 Budgetary Policy and Financial Instruments
4.5 The Interest Rate Policy and the Financial System
4.6 Deficit Financing and the Financial System
4.7 Let Us Sum Up
4.8 Key Words
4.9 Some Useful Books
4.10 Answers/Hints to Check Your Progress

4.0 OBJECTIVES

After going through this Unit, you will be able to:

- describe the concept and objectives of the budgetary policy,
- identify the extent of integration between various segments of financial system and budgetary policy,
- evaluate the impact of budgetary policy on different sectors of the Indian financial system,
- state the role of budgetary policy in the emerging new economic environment, and
- discuss the role of Deficit Finance in financial system.

4.1 INTRODUCTION

The financial system of a State is influenced, to a great deal, by the economic policy of a country. The fiscal policy as a part of economic policy deals with taxation, public expenditure, public borrowing and debt management. The budgetary policy and the budget documents are important parts of fiscal policy. That is why, the budgetary policy and the budget documents, to a significant extent, influence the functioning of a financial system of a country. Hence, in this Unit, we shall discuss the issues relating to budgetary policy and their bearing upon the Indian financial system.

Let us begin with explaining the concepts of fiscal policy and budgetary policy in the next section.

4.2 INDIAN FISCAL POLICY

In the process of economic development, fiscal policy as an important instrument of economic policy plays an important role in the development and planning system of a country. Through fiscal policy, the Government provides public services. At the same time, it is an instrument for re-allocation of resources according to national priorities, re-distribution, promotion of private savings and investments and the maintenance of stability. Fiscal policy is concerned with the aggregate impacts of various policy measures on the prescribed set of objectives. Therefore, it is in a broader framework, a measure to achieve the prescribed objectives in an economy. In other words, fiscal policy is a mean to achieve the chosen objectives like, economic growth, generation of employment opportunities, distributive justice, removal of poverty, price stability, etc.

It is clear from the above discussion that fiscal policy has a multi-dimensional role. Providing social justice to various segments is the major objective of this policy. In a developing country, like India, the fiscal policy has an added importance as it is assigned an important role to achieve full employment and economic stability, and thereby achieving meaningful growth rate. Fiscal policy, on the one hand, concentrates on the resource mobilization in the economy. The system of taxes diverts funds from the private sector to the government sector. On the other side, the system of public expenditure diverts funds from government sector back to the people as they are spent for productive and welfare purposes. Public borrowings are also used for various purposes. Public debt management includes functions like floating of government loans, payment of interest and redemption of debts.

The fiscal policy is formulated to fulfil the following objectives:

i) Mobilization of resources so as to increase the rate of investment and capital formation. This, in turn, accelerates the rate of economic growth,

ii) Reduction of inequalities of income and wealth, or redistribution of income, in other words, an equitable distribution of income,

iii) Increase in employment opportunities, and

iv) Price stability.

In order to achieve these objective, the Government resorts to the following instruments:

i) Taxation

ii) Public Expenditure

iii) Public Debt

These instruments affect the functioning of financial sector in the following manner :

i) **Taxation**

Taxation has a direct bearing on savings, investments and consumption. If the direct tax rates were high, there would be lesser savings and would also affect the consumption pattern. At the same time, if the tax rates are brought down, it would affect public investments. In such a contradictory situation, the Government has to take very precautionary step, as high corporate tax rate would affect the prices adversely. At one point of time, the corporate tax was quite high. However, with the process of liberalization it has gradually been reduced. The reduction in corporate tax creates multiple beneficial effects all round and also attracts foreign investments.

ii) **Public Expenditure**

Public expenditure, apart from influencing the economic growth process, has its real bearing on the activities of financial sector.

In the event of more spending through public investments, various sectors of the economy flourish, which in turn raise the demand for private investments from financial system. For example, if Government develops good infrastructure in a particular zone, more industries would come up and will demand the financial assistance from banks and financial institutes.

iii) **Public Debt**

The public debt comprises of internal and external debt. Internal debt includes market loans, bank temporary loans by way of treasury bills issued to RBI and commercial banks. Public debt policy affects financial sector. When Government has more borrowings, it adopts various tools such as increased level to statutory liquidity ratio to be imposed on banks, issue of treasury bills etc. All these measures reduce the credit capacity of financial institutions and these are left with less credit availability for productive purposes.

Thus, fiscal policy affects savings, investments, credit capacity, demand for credit in a financial system etc. that have direct bearing on operations of financial sector as a whole in the economy.

4.2.1 Budgetary Policy

Broadly speaking, budgetary policy is a policy through which the government uses its expenditure and revenue programmes to produce desirable results and avoid undesirable effects on national income, production and employment. Thus, budgetary policy helps in meeting the objectives set up in the fiscal policy.

The objective of budgetary policy cannot be different from the objective of fiscal policy and consequently economic development of the country. Both have to coincide.

4.2.2 Budgetary System

The document integrating the revenue and the expenditure of Government is called the **'Budget'**. A budget contains the actual estimates of revenue and expenditure of the Government of preceding year, revised estimates of the receipts and payments of the Government for the current year and the estimates for the next year. It has a role to ensure that the tax burden is reasonably imposed. On the other side, it ensures justice in allocation of expenditure among various sectors of the economy.

The budgetary policy is essentially concerned with:

a) Raising of revenue

b) Incurring of expenditure by the Government

The budgetary policy has been modified from time to time and made more pragmatic not only to enhance the tax resources but also to ensure that maximum people are brought within the tax net. The tax GDP ratio in India was just 6% in 1950-51, which increased nearly to 14% in 1999-2000. The Budget statement has been instrumental for providing special incentives for private savings and also encouraging investments in specified areas like housing. The budget strategies are revised every year keeping in view the overall economic growth of the country, requirements of resources, and allocation of funds according to priorities.

Strategies of the Budget (2001-2002)

The broad strategies of the Budget 2001-2002 were determined with the objective of the growth in mind and to ensure:

i) Speeding up of agricultural sector reforms and better management of the food economy.

ii) Intensification of infrastructure investment, continued reforms in the financial sectors and capital market and deepening of structural reforms through removal of

remaining tiresome controls constraining economic activity.

iii) Human development through better educational opportunities and programs of social security.

iv) Stringent expenditure control of non-productive expenditure, rationalization of subsidies and improvement in the quality of government expenditure.

v) Acceleration of the privatization process and restructuring of public enterprises.

vi) Revenue enhancement through widening of tax base and administration of a fair and equitable tax regime.

Table 4.1 : Budget (2001-2002) at a Glance

	(Rs in Crores)
REVENUE RECEIPTS:	231745
TAX	163031
NON-TAX	68714
CAPITAL RECEIPTS:	143478
RECOVERY OF LOANS	151648
OTHER REVENUES	12000
BORROWINGS AND OTHER LIABILITIES	116314
TOTAL RECEIPTS:	**375223**
NON-PLAN EXPENDITURE:	275123
REVENUE ACCOUNT	250341
INTEREST PAYMENT	112300
CAPITAL ACCOUNT	24782
PLAN EXPENDITURE:	95100
REVENUE ACCOUNT	60225
CAPITAL ACCOUNT	34875
LUMP SUM PROVISION FOR ADDITIONAL PLAN	5000
REVENUE DEFICIT	78821
FISCAL DEFICIT	116314
PRIMARY DEFICIT	4014

Check Your Progress 1

1) What do you mean by fiscal policy?

....

....

....

2) How public expenditure as a policy instrument can be used to enhance investment?

....

....

....

3) State whether following statements are true or false:

   i) With the process of liberalization, the corporate tax has been raised. (T/F)

   ii) Human development has been one of the key strategies of union Budget 2001-02. (T/F)

   iii) The objectives of budgetary policy vary with the objectives of fiscal policy. (T/F)

4.3 INDIAN FINANCIAL SYSTEM

We are quite aware of the major components of a financial system, as these have been discussed in Unit-1. Let us discuss the various components of Indian Financial System here.

The Indian financial system consists of variety of institutions, markets and instruments that are closely related with each other. It provides the principal means by which savings are turned into investments. Given its role in the allocation of resources, the efficient functioning of the financial system is of crucial importance in a developing economy, like India.

The financial institutions/financial intermediaries, as they are called, comprise commercial banks, insurance companies, mutual funds, non-banking financial companies, development financial institutions etc. The financial markets comprise of capital market and money market, whereas financial instruments are demand deposits, short-term debt, intermediate term debt, long-term debt and equity, bonds etc.

Broadly the important functions of financial system can be described as under:

i) It enables the pooling of funds for setting up large-scale enterprises.

ii) It provides a way for managing uncertainty and controlling risks.

iii) It provides a mechanism for spatial and temporal transfer of resources.

iv) It generates information that helps in coordinating decentralized decision-making.

v) It provides a payment system for exchange of goods and services.

vi) It helps in dealing with information gap by handling sensitive information discreetly

4.4 IMPACT OF BUDGETARY POLICY ON FINANCIAL SYSTEM

The budgetary policy provides a leeway to integrate various financial intermediaries and make the financial system more vibrant. There are various budgetary policy measures, which set the direction of savings, credit expansion and investments. Depending on various policy measures, the extent of growth of financial system is determined.

4.4.1 Role of Budgetary Policy in the Growth of Financial Institutions

The primary role of a financial institution is to serve as an intermediary between lenders and borrowers. These institutions work under the overall supervision of the Reserve Bank of India. The funds pooled by the financial institutions are invested in diversified portfolios of financial assets. The transaction cost is lower. The financial institutions supply the ultimate lenders with liquid and less risky financial assets. Thus, financial institutions act as intermediaries between investors and savers.

The process of financial intermediation results in:

a) Providing savers with different varieties of financial assets to invest their funds according to their preferences. It enables them to increase their savings.

b) Borrowers are also benefited as finance is provided through the institutions as it is not easily possible to obtain directly from savers.

c) It raises the productivity of aggregate investment, by improving its allocation. This apart, financial intermediaries also perform the important function of facilitating the normal production process and the exchange of goods and services.

The financial institutions, thus, play a vital role in the economic development of the economy. Broadly, these institutions are classified into following categories:

a) Development financial institutions

b) Insurance companies

c) Other Public sector financial institutions

d) Mutual Funds

e) Non-Banking Finance Companies

The objective of budgetary policy is to strengthen the financial base of these institutions and to provide them operational freedom. A distinct feature of the Indian financial system is dominance of public sector institutions. Motivated by socio-

economic considerations, the system has been subject to high degree of regulations. Both entry of a new entity and its expansion have remained under the control of State. There has been a mandatory allocation of credit amongst different sectors including the government. Concessional interest rates have also been introduced.

In the recent past, the following budgetary policy measures have been initiated:

i) The financial institutions have been given more autonomy in their operations. They have also been permitted to expand their operations in the financial sector by opening new outfits.

ii) Prudential norms relating to capital adequacy, income recognition, classification of assets and provisioning have been made applicable to these institutions.

iii) Insurance sector has been opened to the private sector. This will not only provide healthy conditions but also better risk cover and returns to investors. Insurance Regulatory and Development Authority has been set up to monitor the insurance institutions.

iv) Budgetary allocation has been made to expand the capital base of NABARD, which in turn will accelerate the growth of agricultural sector and rural development.

v) Certain tax incentives have been extended for investment in mutual funds.

4.4.1.1 Impact of Budgetary Policy on Banks

The banks mobilize surplus funds through various channels of savings. The flow of savings in the economy directly depends on budgetary policy measures. As already indicated that taxation policy, public expenditure and public debt policy affect consumption and savings, the extent of savings is much related to fiscal measures. Likewise, the expansion of credit also depends on investment policy being pursued by the Government to encourage private investments. If there are more fiscal incentives for industrial expansion, it will attract more demand for credit. Even Government's demand to meet current expenditure would limit the availability of loanable funds from the banking system.

The commercial banks transfer funds from surplus units to deficit units at the minimum operating cost. Today, we have vast network of bank branches operating all over the country. The nationalization of commercial bank in 1969 was a turning point in the history of banking in India. There have been significant achievements and pitfalls during this period. The budgetary policy has initiated a series of measures to make the banks more responsive to economic growth.

Some of the recent measures are as under:

i) The banks are required to be more vibrant and their capital base has been strengthened. To meet the capital adequacy norm of 8%, a budgetary support of over Rs. 20,000 crore is provided to weak banks.

ii) To make the bank credit cost effective, tax on loan interest has been withdrawn.

iii) In the budget document, through rigorous exercises, attempts have been made to bring down the deficit, which in fact has helped banks to control flow of credit to government on concessional rate of interest.

iv) To boost the export business, the government has set up Export Import Bank of India. The initial capital was contributed through budgetary resources.

v) Banks have been facing serious problem with regard to recovery of their loans particularly the non-performing assets. The government has set up Debt Recovery Tribunals to expedite the cases of banks and accelerate recovery process.

vi) The budgetary policy provided specific provisions and incentives for increasing the credit to high-tech agriculture projects.

vii) The banking sector has been provided greater autonomy in their functions. The entry of private and foreign sector banks has been permitted to bring more competitiveness and efficiency in the working of banks.

viii) For greater credit expansion and wider acceptability of banks in rural areas, the Regional Rural Banks (RRBs) have been set up.

ix) The development of housing sector received prime attention in the budgetary policy. National Housing Bank has been set up. Tax concessions have been provided to the borrowers.

x) The budgetary policy has initiated several other policy measures for the benefit of specified sectors like poor people, agriculturist, educational loans, etc.

xi) The Statuary Liquidity Requirement (SLR) and the Cash Reserve Requirement (CRR) of banks have been reduced significantly to release more loanable funds to the banks.

xii) To reduce its stake in the ownership of nationalized banks, the Government has decided to reduce its equity to 33% in case of such banks.

Thus, the budgetary policy has provided greater flexibility in banking operations and has made them more stronger to play a vital role in the financial system.

4.4.2 Budgetary Policy and Financial Markets

In the Indian financial system, there are two broad segments of the financial market:

i) money market, and

ii) capital market.

i) **Money Market**

The money market deals with short-term debt. The principal players in the money market are the commercial and other banks in addition to LIC, UTI, Mutual Funds, and non-banking financial companies. These intermediaries lend funds on a short-term basis to create an active inter bank call loan market. The Discount and Finance House of India (DFHI) provides liquidity to money market instruments by creating a secondary market.

ii) **Capital Market**

The capital market deals with long-term debts and stock (equity and preference). Each of these markets has a primary and secondary segment. New financial assets are issued in the primary market while existing financial assets are traded in the secondary market.

The growth of capital market is influenced, to a great extent, by various budgetary policy measures. For example, the taxation policy of corporate tax, dividend tax, capital gain tax, fiscal incentives for small savings etc. have direct impact and set the direction of growth of capital market. On the other hand, various fiscal incentives for industrial expansion would cause more demand from capital market by industrial sector.

The instruments of capital market have long period for maturity. It is a source of raising capital by issuing securities. The primary capital market facilitates the formation of capital. The secondary market consists of stock exchanges recognized by the government. The National Stock Exchange and Over the Counter Exchange of India provide liquidity to the securities. The Securities and Exchange Board of India (SEBI) oversees and monitors the functioning of securities market and operations of intermediaries like mutual funds and merchant banks. Besides, there is a market for government securities which deals with debt securities issued by central/ state governments, all India financial institutions and other autonomous institutions.

The following budgetary provisions helped widening of financial markets and their operations smoothened:

a) With a view to encourage secondary market operations, the maximum coupon rate which was as low as 6.5 % in 1977-78 was raised to 11.5 % in 1985-86 and thereafter restriction on maximum coupon rate was removed.

b) A number of instruments were introduced in the market such as 182-day Treasury Bill, certificate of deposits, commercial paper and inter- bank participations.

c) The Discount and Finance House of India (DFHI) was set up in 1988 by Reserve Bank of India and other financial institutions to facilitate smoothening of short-term liquidity imbalances and bring flexibility to the money market.

d) The interest rates have been largely deregulated.

e) Tax incentives have been provided for capital gains investment in mutual funds and investment in infra-structure development bonds.

f) To provide further boost to money market operations, banks and other financial institutions have been allowed to set up money market mutual funds.

g) Foreign institutional investors have been encouraged to participate in the financial markets.

h) The concept of tax-free bonds was introduced for mobilizing greater resources.

4.4.3 Budgetary Policy and the Financial Instruments

Financial instruments are generally defined as monetary obligation of a borrower of funds (the issuer of the instrument) to the holder of the instruments. For the issuer of the instrument, it is a liability or in other words, financial obligation, for the holder it is a financial asset.

Financial instruments may be issued by economic units (private as well as public). The major financial instruments in an economy are as under:

i) **Demand Deposits**

Demand deposits are the financial instrument which are payable on demand to the owner by the holder. It may or may not carry interest. These are usually held by the banks by way of current and savings deposits and by post offices by way of savings accounts.

ii) **Short–Term Debt**

This is a promise to repay a specified sum along with agreed rate of interest within a short period of one year. Treasury bills, commercial papers, certificates of deposits and few other innovative instruments have been introduced in the system.

iii) **Long–Term Debt**

These are the debt instruments repayable over a period of 5 to 7 years in case of corporate sector and over 10 years in case of government bonds. They carry a specified coupon rate. Private and public sector debentures and bonds fall in this category. The debt instruments have been made more lucrative with variety of options and reasonably better yield.

iv) **Equity Stock**

This is a popular means of raising resources as capital by the corporate sector. Being owners, the equity shareholders have residual interest in the income of the company as they receive dividend after the claims of all creditors are met.

The budgetary policy has aimed from time to time that various financial instruments depending on variety of needs are brought into the system. They perform both the functions of financial assets and financial liabilities.

In this direction, the budgetary policy has a very important role because the nature of new financial instruments and their innovativeness depend on budgetary policy decisions. Such incentives are in the form of tax incentives to attract more savings, growth of investments to meet increased money supply and growth of capital market in tune with changes in policy measures for industrial growth.

The budgetary policy has made the financial instruments as discussed above, more acceptable. Some of the other financial contracts like forward futures, swaps, options and pension funds have been introduced in the system. The following are some of budgetary policy measures, which have increased the utility of above instruments in the financial system.

i) The ceiling coupon rate on bonds has been abolished.

ii) Some specified bonds such as infrastructure and power development have been given tax benefit.

iii) The volume of money market instruments has been increased.

iv) Number of steps has been taken to make short-term debt

instruments more acceptable. The eligibility norms have been liberalized from time to time.

v) Mutual funds investments have also been given certain rebate in tax .

vi) Specific guidelines have been issued for operations of forward futures, swaps, options etc.

Check Your Progress 2

1) State three major functions of financial intermediaries.

....

....

....

2) What major steps have been adopted in the recent years to make the banks more vibrant?

....

....

....

3) State how the budgetary policy affects the financial markets

....

....

....

4.5 THE INTEREST RATE POLICY AND THE FINANCIAL SYSTEM

The interest rate policy basically aims at:

i) ensuring government borrowings at cheaper rates,

ii) supporting certain activities through concessional lending rates,

iii) mobilizing substantial savings, and

iv) ensuring stability in the macro-economic system.

The interest rates in India had, in the past, been substantially regulated by the Reserve Bank of India which had the following features:

i) Interest rates on deposits with commercial banks were subject to ceiling.

ii) Interest rates on loans were subject to floors.

iii) Interests rates payable by companies on deposits were subject to a ceiling.

iv) Interest rates charged by development financial institutions were subject to floors.

v) Interests rates payable on small saving schemes were fixed by the government.

The interest rate regime in India has undergone a rapid transformation during recent years. The structure of interest rates, which was extremely complex, has now been rationalized. Banks are now free to determine their own Prime Lending Rate and to prescribe the maximum spread over it. Loans upto Rs. 2 lakhs are to be granted at rates not exceeding the Prime Lending Rate of relevant maturity. The money market rates have been completely freed. So are the rates at which corporate entities can borrow funds from the capital market. Deposit rates have also been deregulated, except the interest rate on saving accounts, which is determined by the Reserve Bank of India.

The interest rate deregulation has influenced the government securities market also. The Central Government has been able to meet its requirements from the market through the auction mechanism. The rates of interest settled at the auctions have come to reflect truly the market conditions. This has been proved both in relation to dated securities and treasury bills. With abundant liquidity, the interest rates have clearly shown a downward decline. The 364-day treasury bills are increasingly being used as a benchmark for fixing other rates in the system. With the development of an active government securities market, where rates are more or less determined by the market, the emergence of the open market operations as an indirect instrument of monetary control will assume importance. Steps are being taken to bring about significant institutional changes in the government securities market.

With the reform in the interest rate structure, an emphasis has been placed on widening and deepening of various segments of the financial sectors of money market and capital market. In the budget 2002-03, Governement has decided to link interest rate on small savings with the average yield on Government Securities of comparable maturity.

Role of Budgetary Policy in the emerging new economic environment:

India has been pursuing the policy of economic reforms since 1991-92. The major policy initiatives are:

i) Macro economic stabilization through fiscal policies.

ii) Trade policy reforms to provide stimulus to exports.

iii) Industrial policy reforms to provide greater competitive environment to industries.

iv) Wide spread reforms in financial sectors to achieve financial efficiency.

The monetary and fiscal policies aim at controlling aggregate demand in tune with the growth of the economy. These policies are known as stabilization policies. The budgetary policies act as a link between both, the macro economic stabilization and structural policies. Therefore, budgetary policy has a very crucial and significant role in creating an environment conducive to economic growth.

There has been a number of policy measures taken in the recent years to accelerate the process of economic reforms. These include:

i) Wide range of financial sector reforms including banking sector, capital market operations, non-banking financial companies and other development financial institutions.

ii) Serious attempts have been made through budgetary policy to correct fiscal imbalances.

iii) The tax laws has been rationalized to ensure:

   a) lower personal and corporate taxes.

   b) broaden the tax base; and

   c) inflation adjustment of tax rates.

iv) The policy has been adopted for progressive expansion of MODVAT system.

v) Continued rationalization of custom tariffs structure.

vi) The new economic policy has lent more emphasis on large flow of direct foreign investment.

The above analysis indicates that budgetary policy has an important contribution in achieving the goals and objectives of new economic policy.

4.6 DEFICIT FINANCING AND FINANCIAL SYSYTEM

According to the Planning Commission, the term "Deficit Financing" is used to denote direct addition to gross national expenditure through budget deficits whether the deficit is on revenue or on capital account. The essence of such a policy lies, therefore, in government spending in excess of the revenue it receives in the shape of taxes, earnings of state enterprises, loans from public, deposits and funds and other miscellaneous sources.

The government may cover the deficit either by:

i) Running down its accumulated balance (withdrawing its cash balances),

ii) Borrowing from the central bank,

iii) Borrowing from commercial banks, or

iv) Creating new money by resorting to the printing press.

In short, deficit financing means incurring public expenditure in excess of public receipts from all sources. The quantum of deficit financing in a given period can be measured by variations in the financial assets and the non-monetary liabilities of the RBI and of the treasury.

The deficit financing has affected the operations of financing system to a large extent as financial system especially the banks were directed to provide significant credit support for government expenditure (current and capital both).

The period since early 1970s was characterized by weakening of fiscal discipline leading to large expansion in the central government's domestic and foreign currency borrowing requirements .The ratio of the gross fiscal deficit to GDP increased from 3.5 % in 1970-71 to 8.4% in 1990-91. The obligatory cash reserve requirements of scheduled banks (held at the central bank) and the statutory liquidity ratio (to be met through holdings of government and other approved securities), reduce the resources of banks. With a view to keeping the government's borrowing costs down, the yield on both treasury bills and long-term paper were left artificially low. This limited the demand for government paper by banks (and other financial intermediaries, such as insurance companies and provident funds). Residual financing needs of the government were, therefore, met by the Reserve Bank.

Such a mix of policies had deleterious long-term effects as large fiscal deficits became chronic and continuous escalation of the above-mentioned two ratios became necessary. In the early 1970s the cash reserve ratio for the banks was as low as 3% and the statutory liquidity ratio was 25%. By 1991-92, the CRR rose to 5% and SLR was 38.5%. At the same time, the Reserve Bank's holding of Central Government debt (i.e., its monetisation of the Government deficit) ballooned. By 1991, it was clear that the burden of Government debt was becoming unsustainable and that a significant improvement in the primary deficit was needed.

Sustained fiscal adjustments must underpin further reforms. In the absence of credible fiscal control and price stability, there is some risk that interest rate deregulation could result in overshooting and disrupt the reform process. The Government of India has committed itself to continued reduction in its gross fiscal deficit from the level of 5.7%

reached in 1992-93. The fiscal deficit as a proportion of GDP was budgeted at 4.7 per cent in 2001-02 (BE) compared with 5.5 per cent in 2000-01 on the basis of original unaudited figures. Trends in the financial year 1993-94 were somewhat worrying, with the seasonally unadjusted deficit in the first half of the year running at an annual rate roughly triple the targeted level. This reflects revenue shortfalls partly related to sluggish industrial activity and delay in sale of equity in public enterprises. There has been agreement between Reserve Bank and Government that this incremental deficit should not be monetised. Accordingly, Government has resorted to additional borrowing through treasury bills and zero-coupon bonds at market-related rates. Fortunately, this unplanned increase in the borrowing requirement has occurred at the time when the domestic market is flush with funds, but this is short-term phenomenon that cannot be relied on. Nonetheless, the use of these market instruments has meant that the monetised deficit can be kept under control.

Check Your Progress 3

1) List the three measures initiated in the budgetary policy to make the banks more responsive to growth.

....

....

....

2) Name any two measures which have been taken to strengthen the capital market?

....

....

....

3) Name two measures through which the Government cures its budget deficit.

....

....

....

4.7 LET US SUM UP

Budgetary Policy as a part of economic policy deals with taxation, public expenditure, public borrowings and debt management. The budgetary and monetary policy and the budget documents influence the functioning of financial system to a great extent.

Taxation policy has a direct bearing on savings, investments and consumption. Change in the direct tax rates affect the

level of saving and the consumption patterns. Public expenditure also influences the linkage between public investment and its spill over effect on private investment. Public debt policy also affects financial sector through changes in SLR and CRR, which in turn, reduce the credit capacity of the financial institutions. Thus, budgetary policy affects savings, investments, credit capacity demand for financial system, which, in turn, have direct bearing on the financial system.

A lot of changes have been made in the Indian budgetary policy after July 1991 to boost the financial system and make it more vibrant. The Financial Institutions have been given more autonomy after the beginning of economic reforms since July, 1991. As a major policy change, the insurance sector has been opened to private sector. Budgetary Policy has also provided greater flexibility in banking operations and has made them stronger to play a vital role in the financial system. The budgetary provisions have also helped widening the financial markets. A number of financial instruments such as Treasury Bills of shorter duration, certificate of deposits, commercial papers etc. have been introduced.

The deficit financing has affected the operations of financial system to a large extent as financial system, especially the banks, provide a large amount of support through purchase and sale of government securities. Since early 1970s, the domestic and foreign currency borrowing requirements of the Government have expanded to a great deal. In order to keep the Government's borrowing cost down, the yield on the long-term debt has been kept low. Such a policy measures has deleterious long-term impact on the financial system.

4.8 KEY WORDS

Balance of Payment: A systematic and summary record of a country's receipts and payment made to the rest of the world.

CRR : Cash reserves to be kept by the Commercial Banks as certain proportion of their demand and time deposits.

Economic growth : The expansion of the per capita output of the economy. In other words, a tendency of rise in real level of net national product.

Exchange rate : The price at which one currency can be exchanged for another.

Human development : The process of widening people's choices and the level of well being

Progressive tax : Progressives taxes refer to increasing rate of taxes at the increasing level of income.

Propensity to consume : The desire to consume expressed as the proportion of income spent on goods and services.

Pump priming : Attempt to reflate the economy by running a small budgetary deficit.

Redemption of debt: The repayment of an outstanding loan by the borrower in order to cancel it.

4.9 SOME USEFUL BOOKS

Economic Survey – Government of India, 2001, 2002

Union Budget Document, 2001-02, 2002-03

I.C. Dhingra (2001)— *Macro Economics Analysis and Policy,* Sultan Chand and Sons, New Delhi

Rudra Dutt (2001) — *Indian Economy,* S. Chand and Company, New Delhi

Cooper, S.K. and Fraser, D.R. (1990): *The Financial Market Place,* IIIrd edition, Westley Publishing Co., Massachuales, New York.

4.10 ANSWERS/HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Fiscal Policy is a policy instrument, which deals with the taxation, public expenditure and public debt to achieve the desired objectives.

2) By making the public expenditure in socio-economic infrastructure, which in turn, motivates the private investment.

3) (i) False (ii) True (iii) False

Check Your Progress 2

1) i) Serve as an intermediary between lenders and borrowers.
   ii) Provides savers with different varieties of financial assets to invest their funds.
   iii) Provides borrowers with the opportunity to obtain funds.

2) i) Debt Recovery Tribunal has been set up to expedite the cases of banks suffering from the problem of recovery of their loans.

   ii) Entry of private and foreign banks has been permitted to make the system more competitive and effective.

   iii) The Statutory Liquidity Requirements (SLR) and Cash Reserve Requirements (CRR) have been reduced significantly to release more lonable funds to the banks.

3) Various policy measures of budgetary policy, such as taxation affect the level of saving and investment, which in turn, affects the functioning of financial markets.

Check Your Progress 3

1) i) Withdrawal of tax on loan interest.

   ii) Setting up Export-Import Bank of India to boost the export business.

   iii) Reduction of CRR and SLR to release more loanable funds to the banks.

2) i) Removal of coupon rate.

   ii) Introduction of new instruments like Treasury Bill, Certificate of Deposits, Commercial Paper and inter-bank participation.

3) i) Market Borrowing

   ii) Deficit Financing

UNIT 5 COMMERCIAL BANKS IN INDIA

Structure

5.1 Objectives
5.2 Introduction
5.3 Classification of Commercial Banks
    5.3.1 Public Sector Banks
        5.3.1.1 State Bank of India Group
        5.3.1.2 Nationalised Banks
    5.3.2 Private Sector Banks
        5.3.2.1 Privately Owned Banks
        5.3.2.2 Foreign Banks
    5.3.3 Scheduled Banks
5.4 Resources of Commercial Banks
    5.4.1 Paid-up Capital and Reserves
    5.4.2 Deposits
    5.4.3 Borrowings
5.5 Employment of Resources
5.6 Reserve Bank's Directives and Norms
    5.6.1 Priority Sector Advances
    5.6.2 Prudential Norms
    5.6.3 Income Recognition
    5.6.4 Asset Classification and Provisioning
    5.6.5 Capital Adequacy Norms
5.7 Problem of Non-Performing Assets
5.8 Let Us Sum Up
5.9 Key Words
5.10 Some Useful Books
5.11 Answers/Hints to Check Your Progress

5.1 OBJECTIVES

After reading this Unit, you will be able to –

- Explain the structure of Commercial Banks in India,
- Describe the sources of funds for Commercial Banks and their utilisation,
- Discuss important regulatory directives issued and norms laid down by Reserve Bank of India, and
- Identify the problem of non-performing assets of banks.

5.2 INTRODUCTION

Commercial Banks are the oldest and the largest banking institutions in India. Some of them are more than hundred years old. Their branches are spread all over the country and have penetrated in the countryside as well.

Commercial Banking has passed through three distinct phases in India since Independence. The period 1955-1970

witnessed the genesis of public sector in Indian banking commencing with the setting up of the State Bank of India in 1955 and ending with the nationalisation of 14 major banks in 1969.

The two decades after nationalisation of banks i.e. the seventies and eighties witnessed the conversion of class banking into mass banking. During this period branch expansion took place on a large-scale, followed by recruitment of large number of bank employees, expansion in priority sector advances, especially for the poor and neglected sectors. Loan Melas were the main features of this period. On the other hand, the Reserve Bank of India's regulatory control intensified over various facets of banking operations.

The post-nationalisation era was not without its resultant problems. With poor training, employee efficiency and productivity went down, problem of non-recovery of loans cropped up, and pre-emption of funds in meeting statutory requirements went up, resulting in reduced profitability of banks.

It was such a situation in 1991 when the new economic policies were launched by the Government. A Committee on financial sector under the Chairmanship of Shri M. Narashimham was appointed which suggested measures of far-reaching significance to improve efficiency, productivity and profitability of banks. These measures have been largely implemented. In this Unit, you will study the position of Commercial Banks in India in the present situation, after the reform measures have largely been implemented.

5.3 CLASSIFICATION OF COMMERCIAL BANKS

On the basis of ownership and control over management commercial banks in India are classified into two broad categories i.e.

i) Public Sector Banks, and
ii) Private Sector Banks.

Public Sector banks account for the major share of the banking business in India and are sub-classified into two categories i.e.

a) *State Bank of India Group*, and
b) *Nationalised Banks.*

5.3.1 Public Sector Banks

5.3.1.1 State Bank of India Group

This group comprises State Bank of India and its seven

subsidiaries which is the largest commercial bank in India. State Bank of India came into existence in 1955 when the Government converted the then existing Imperial Bank of India into State Bank of India under the State Bank of India Act, 1955. At that time, about 93% of its shares were held by the Reserve Bank of India. State Bank of India acts as the agent of Reserve Bank of India at places where the latter has no office of its own. In 1959, eight state associated banks were converted into the subsidiaries of State Bank of India under the State Bank of India (Subsidiary Banks) Act 1959. Later, one of them was merged with another. Thus, State Bank Group comprises of eight banks. The objective of formation of State Bank Group was to accelerate the extension of banking facilities in the countryside.

5.3.1.2 Nationalised Banks

After about a decade, in July 1969, 14 major commercial banks in India were nationalised by the enactment of Banking Companies (Acquisition and Transfer of Undertakings) Act 1970. A decade later in 1980, 6 more commercial banks were nationalised with deposits of Rs. 200 crore each. One of them was subsequently merged with another, thus, the total number of nationalised banks is 19 at present.

The decision to nationalise the major commercial banks was taken with the objective of opening a large number of branches throughout the country, especially in the rural areas and to mobilise deposits on a massive scale for the purpose of lending to productive purposes. These were the projects, which had remained neglected so far, i.e. agriculture, small industries and small businesses, weaker sections, etc. Initially, cent percent ownership of nationalised banks was vested in the Government of India. Subsequently, after the amendment in the Act, private share holding has also been permitted with the provision that the share of the Government shall not fall below 51%. A few banks have since issued shares to the public, with the result the Government shareholding percentage has been reduced.

5.3.2 Private Sector Banks

5.3.2.1 Privately Owned Banks

Private Sector banks fall in two categories. Those private sector banks which were in existence at the time of nationalisation are 23 and are called Old Private Sector Banks. Till 1993 no new bank could be established in India. In 1993, Reserve Bank of India formulated guidelines for the establishment of new private sector banks in India. According to these guidelines, a new bank was required to have a minimum capital of Rs. 100 crore and to observe the capital adequacy norm of 8% from the very beginning. Nine

new banks were set up according to these guidelines. One of them was subsequently merged with another. After the merger of ICICI Ltd., one of the All India Development Banks in India, with its subsidiary ICICI Bank Ltd. on March 30, 2002, ICICI Bank Ltd. has become the second largest commercial bank in India after the State Bank of India. It is obviously the largest bank in the private sector. In 2001, these guidelines were revised with the effect that the amount of capital has been raised to Rs. 200 crore (to be further raised to Rs. 300 crore) and capital adequacy norm was raised to 9%.

5.3.2.2 Foreign Banks

At present there are 41 foreign banks from 21 countries operating in India. They are the branches of banking companies incorporated outside India. There were 194 branches of foreign banks operating in India as on June 30, 2001.

5.3.3 Scheduled Banks

According to Section 42 of the Reserve Bank of India Act, 1934, banks—both public sector and private sector banks, are given the status of a Scheduled Banks, if their names are included in the Second Schedule to the Reserve Bank of India Act. For this purpose, the bank must satisfy the following conditions:

i) It must have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakhs,

ii) It must satisfy the Reserve Bank of India that its affairs are not being conducted in a manner detrimental to the interest of its depositors, and

iii) It must be a State Co-operative Bank or a company or an institution notified by the Central Government in this behalf, or a corporation, or a company incorporated under any law.

Thus, besides Commercial Banks, Regional Rural Banks, State Co-operative Banks and Urban Co-operative Banks are also entitled to get the status of a Scheduled Banks.

Check Your Progress 1

1) List various categories of Commercial Banks in India.

....

....

....

2) Fill up in the blanks:

i) Commercial Banks in India have passed through .... phases since Independence.

ii) State Bank group comprises of .... Banks.

iii) The total number of Nationalised Banks at present is ....

iv) .... bank is the largest Bank in the private sector.

3) Which are the conditions required to be satisfied by a bank for placing it under the category of Scheduled Bank under Section 42 of RBI Act 1934?

....

....

....

5.4 RESOURCES OF COMMERCIAL BANKS

Banking business essentially lies in the acceptance of deposits for the purpose of lending and investment. Acceptance of deposits thus, constitutes the main source of funds for them. Their own funds constitute a small percentage of their total resources. As we shall see later, efforts are being made during recent years to increase the owned funds of the banks also.

5.4.1 Paid Up Capital and Reserves

The authorised capital of nationalised banks is Rs. 1500 crore each. The Central Government has subscribed to the 100% paid-up capital in case of some banks, while in other cases, its percentage holding has declined with the issuance of shares to the public.

Banks transfer 20% (now 25%) of their net profits to a Statutory Reserve Fund every year. Besides, they also maintain other Reserve Funds, e.g. Capital Reserves, Share Premium, Revenue and other reserves and Investment Fluctuation Reserve.

5.4.2 Deposits

Deposits from the public, institutions, and organizations constitute the bulk of the resources of commercial banks. They accept deposits under three types of deposit accounts:

i) Fixed Deposits: the minimum period of such deposits is 15 days

ii) Savings Deposits

iii) Current Deposits

No interest is payable on current deposits, while interest on savings bank accounts is prescribed by Reserve Bank of India. Currently it is payable @ 4% p.a. Interest is calculated on the minimum balance held in the savings accounts from 11th day of the month till the last day of the month.

Interest rates on fixed deposits were prescribed by Reserve Bank of India till a few years ago. Now, such interest rates are completely deregulated. Banks are permitted to prescribe their own interest rates for fixed deposits of different maturities. At the stance of the Reserve Bank of India, banks pay slightly higher rates on bulk deposits of Rs. 15 lakh and above and on deposits held in the names of senior citizens (i.e. persons of age 60 years and above).

Deposits with Commercial banks, as well as with Regional Rural Banks and Co-operative banks are insured by Deposit Insurance and Credit Guarantee Corporation of India upto an amount of Rs. 1 lakh in each account. These banks pay the insurance premium @ 5 paise per cent to the corporation for this insurance.

Scheduled Commercial Banks also solicit large deposits through certificates of deposits. The outstanding amount of CDs issued by them stood at Rs. 1695 crore as on October 20, 2000, but declined to Rs. 823 crore as on October 5, 2001.

5.4.3 Borrowings

Banks augment their resources by borrowings also. Sources of such borrowings are:

i) Reserve Bank of India

ii) Other Banks

iii) Other Institutions and Agencies.

Reserve Bank of India provides refinance for export credit and also provides short-term funds under its Liquidity Adjustment Facility (explained fully in Unit on Money Market). Moreover, banks get refinance from other Apex Banks like Exim Bank, IDBI etc.

5.5 EMPLOYMENT OF RESOURCES

As you have seen, bulk of banks' funds are raised in the form of deposits, which are repayable on demand or after a specified period. Banks, therefore, employ these funds partly in liquid assets like cash balances with themselves and other banks and money at call and short notice and the rest of the amount is either invested in securities or given in the form of loans and advances.

i) **Cash and Balances with other Banks**

These are the most liquid assets of a bank and are called the first line of defence, because banks can immediately repay the claims of the depositors with these balances. Banks keep a reasonable amount of cash, say 10% or so of deposits, in such balances.

ii) **Money at Call and Short Notice**

The surplus money with the banks is lent to other banks which are in need of funds for a day or a few days. Banks earn interest on such amount lent to other banks. The interest rate varies from day to day on the basis of demand for and supply of funds.

iii) **Cash Reserves with Reserve Bank of India**

Under Section 42 of the Reserve Bank of India Act, 1934, scheduled commercial banks are required to maintain at least 3 % of their net demand and time liabilities with the Reserve Bank of India. This is the statutory minimum limit, Reserve Bank of India is empowered to raise it to a higher percentage of upto 20%.

With effect from June 1, 2002, the Cash Reserve Ratio (CRR) is required to be maintained @ 5% (reduced from 5.5%). In recent years, Reserve Bank of India has gradually reduced this rate. With every reduction in CRR, Commercial Banks' balances with Reserve Bank of India are released to them, thereby increasing their liquidity. Reserve Bank of India pays interest at bank rate on eligible balances i.e. balances held in excess of statutory 3% limit.

iv) **Investments**

Banks invest substantial portion of their deposit liabilities in investments. Primarily, banks are under compulsion to invest in Government and other approved securities to meet the Statutory Liquidity requirement under section 24 of the Banking Regulation Act, 1949.

Besides, Reserve Bank of India has also permitted the banks to invest in corporate securities, i.e. equity shares, convertible bonds and debentures within the ceiling of 5% of their total outstanding advances as on March 31 of the previous year. Thus, commercial banks do invest in corporate securities, predominantly, bonds and debentures.

Investments of banks are shown under the following head in their Balance Sheets :

1) Government Securities
2) Other approved securities
3) Shares
4) Debentures and Bonds
5) Subsidiaries and Joint Ventures
6) Others (Commercial Paper, Indira Vikas Patras, Units of UTI and Mutual Funds)

Though the Statutory Liquidity Requirement at present is 25% of net demand and time liabilities, banks do invest more than this percentage, which is mainly due to their investments in corporate bonds and debentures. The investment-deposit ratio of Scheduled Commercial banks (on an outstanding basis) was 38.5% as on March 23, 2001.

v) **Loans and Advances**

Granting loans and advances is the principal business of commercial banks. There are three forms in which such loans are granted :

a) Bills purchased and discounted,
b) Cash credits, overdrafts and loans repayable on demand, and
c) Term loans.

a) **Bill of exchange** arises out of genuine trade transactions. When the bills are payable at sight or presentment, banks purchase them from customers (i.e. drawers' of the bills). In case of time bills or usance bills banks discount them.

b) **Cash Credit** is a running account wherein a cash credit limit is prescribed for a customer. He is permitted to withdraw the amount any time he likes and may return the money whenever he is able to do so. Interest is charged on the actual amount lent and for the period of loan.

Overdraft is a temporary facility which is granted to account holders. They are permitted to draw more than their deposits for some exigency or urgent work. Short-term loans are granted to the customers, which are repayable on demand.

c) **Term loans** are loans for medium to long periods. Such loans are granted by banks either singly, or jointly with term lending institutions. These loans are meant for investment in fixed assets or for expansion, modernisation, etc.

On the basis of security taken by banks, loans are divided into:

i) Secured by Tangible Assets (including advances against book debts)

ii) Covered by Bank/Government guarantees

iii) Unsecured

Bulk of loans fall in (i) above, and the least in (iii) above.

vi) **Interest Rate Policy**

Reserve Bank of India has introduced financial sector reforms to provide operational flexibility to the banks. Till 1994 interest rates charged by banks on their advances were regulated by Reserve Bank of India. In October 1994, Reserve Bank introduced the Prime Lending Rate (PRL) as the minimum lending rate chargeable by banks to their borrowers with Credit Limit above Rs. 2 lakhs. Thereafter, banks were given autonomy to fix their own PLR and maximum spread thereon. At present, banks are permitted to determine their own PLR. They are also permitted to offer tenor linked PLRs, i.e. different PLRs for loans with different maturities, with effect from April 19, 2001. Commercial banks have been permitted to lend at rates below PLR to exporters and other credit worthy borrowers including public enterprises.

vii) **Sectoral Deployment of Bank Credit**

Commercial banks serve the needs of different sectors of the economy. They not only provide finance to industry and trade, but are also engaged in the business of granting consumer credit, retail credit and housing loans, etc. Their priority sector advances constitute over 40% of the bank credit. The following table shows the sectoral employment of outstanding bank credit as on July 27, 2001.

Table-5.1
Sectoral Deployment of Bank Credit as on July 27, 2001

Sectors	Amount (in Rs. crore)
1. Industry (Medium & Large)	1,60,175
2. Wholesale Trade (other than foodprocurement)	16,567
3. Public Food Procurement Credit	51,027

	(in Rs. crore)
4. Priority Sectors :	
(i) Agriculture	52,076
(ii) Small Industries	53,241
(iii) Other Priority Sectors	48,839
Total	**1,54,156**
5. Other Sectors	
(i) Housing	17,891
(ii) Consumer Durables	6,793
(iii) Non-Banking Finance Companies	7,491
(iv) Loans to individuals	1,454
(v) Real Estate Loans	1,912
(vi) Other Non-Priority Sector Personal Loan	18,415
(vii) Advances against fixed deposits	19,383
(viii) Tourism & Tourism related hostels	1,473
Total	**98,723**
6. Export Credit	3,227
Total	**3,39,477**

Source : Report on Trend & Progress of Banking in India (2000-01).

Check Your Progress 2

1) Identify the main sources of augmentation of banks' resources by borrowings.

....

....

2) What is the maximum limit to which Cash Reserve Ratio (CRR) can be increased by RBI?

....

....

3) List the various forms in which loans are granted?

....

....

5.6 RESERVE BANK'S DIRECTIVES AND NORMS

5.6.1 Priority Sector Advances

Indian commercial banks (both in public and private sectors) are under an obligation to provide loans to the priority sectors as per the following targets laid down by Reserve Bank of India :

Total Priority Sector Advances : 40% of the net bank credit

Total Agricultural Advances : 18% of the net bank credit

Advances to Weaker Section : 10% of the net bank credit

For foreign banks the targets are as follows:

Total Priority Sector Advances : 32% of the net bank credit

Advances to Small Scale Industries : 10% of the net bank credit

Export Credit : 12% of the net bank credit

Priority sectors advances include advances to agriculture (direct and indirect), small-scale industries, transport operators, retail trade and small business, professional and self-employed persons, housing loans to weaker sections, and others, and investment in specified bonds of HUDCO, NABARD and National Housing Bank.

5.6.2 Prudential Norms

To bring about reforms in the functioning of commercial banks, Reserve Bank of India has prescribed prudential norms for banks as follows :

1) **Non-Performing Assets**

An asset shall be treated as non-performing asset in the following circumstances :

i) Interest and/or instalment of principal remain overdue for a period of more than 180 days in respect of a term loan.

ii) An account remains out of order for a period of more than 180 days in respect of overdraft and Cash Credit Account.

iii) A bill of exchange remains overdue for a period of more than 180 days.

iv) Interest and/or principal of short-term agricultural loan remains overdue for two harvest seasons.

The above-mentioned period of 180 days shall be reduced to 90 days from the year ending March 31, 2004.

5.6.3 Income Recognition

Banks are required not to take to income account interest on any non-performing asset. But, interest on advances

against term deposits, Indira Vikas Patra, Kisan Vikas Patra and Life Policies may be recognised, provided adequate margin is available in the accounts. If government guaranteed advances become NPA, interest on such advances should not be taken to income account unless the interest has been realised.

5.6.4 Asset Classification and Provisioning

All non-performing assets in the advances portfolio are to be classified into the following three categories :

i) *Sub-Standard Asset* : If the asset has been an NPA for a period less than or equal to 18 months.

ii) *Doubtful Asset* : If it remains NPA for a period exceeding 18 months.

iii) *Loss Asset* : Where loss has been identified by the bank/ internal/external auditor but the amount has not been written off wholly..

The above will not apply to :

i) State Government guaranteed advances where guarantee is not involved, and

ii) Central Government advances where the Central Government has not repudiated the guarantee.

All performing assets will be classified as standard assets.

Banks are required to make provisions in their books as follows:

i) *Standard Assets*: 0.25% on global portfolio basis

ii) *Sub-standard Assets*: 10% of the outstanding balance

iii) *Doubtful Assets*: 100% on unsecured portion and the following percent on the secured portion—

20% if the doubtful asset is upto 1 year

30% if the doubtful asset is over 1 year and upto 3 years

50% if the doubtful asset is over 3 years

iv) *Loss Assets*: 100% of the outstanding amount

I) Exposure Norms

To minimise the risks inherent in lending, Reserve Bank of India has prescribed Exposure Norms for the Commercial

Banks. Under these norms, the maximum amount that can be granted to a single borrower and/or group of borrowers by way of fund based and non-fund based facilities as well as in investment in their shares (upto the prescribed ceiling discussed below) are prescribed as follows with effect from March 2002.

i) *Individual Borrowers* : 15% of capital funds of the bank (paid up capital and free reserves).

ii) *Group Borrowers* : 40% of capital funds (it can go up by additional 10% in case of financing infrastructure projects alone).

II) **Norm for Exposure to Capital Market**

Banks invest their funds in corporate securities and lend against shares to individuals, brokers, etc. Reserve Bank of India has prescribed the norms for their exposure to capital market. Such exposure in all forms has been restricted to 5% of total outstanding advances (including commercial paper) as on March 31 of the previous year. The ceiling of 5% thus covers (w.e.f. May 11, 2001) :

a) Direct investments in equity share and convertible bonds and debentures,

b) Advances against shares to individuals for investment in equity shares, bonds, debentures, units of equity oriented mutual funds, and

c) Secured and unsecured advances to stock brokers and guarantees issued on behalf of stock brokers.

5.6.5 Capital Adequacy Norms

Reserve Bank of India has prescribed Capital Adequacy Norms for Commercial Banks since 1992. All banks are required to maintain Capital adequacy norm of 9% with effect from March 31, 2000 (raised from earlier norm of 8%).

The basic objective of prescribing these norms is to compel the banks to increase their capital funds (as defined below) with the increase in the risks associated with different types of assets. For this purpose different assets of the bank are assigned different risk weights—from 0 to 100. The risk-adjusted values of assets are, thus, arrived at. The capital funds of the banks should be at least equal to the prescribed percentage of risk-adjusted values of the assets. This ratio is, therefore, called **Capital to Risk-Weighted Asset Ratio (CRAR)**. Presently this required percentage is 9%.

Capital funds include the following:

Tier I Capital includes :

i) Paid up capital, statutory reserve and other disclosed free reserves, if any, and

ii) Capital reserves representing surplus arising out of sale proceeds of assets.

The total of (i) and (ii) above will be reduced by :

a) Equity investments in subsidiaries of the bank,

b) Intangible assets, and

c) Losses in the current period and previous periods.

Tier II Capital includes :

i) Undisclosed reserves and cumulative perpetual preference shares,

ii) Revaluation reserves (at a discount of 55%),

iii) General provision and loss reserves (including general provisions on standard assets not more than 1.25%),

iv) Hybrid debt capital instruments, and

v) Subordinated debt (upto 50% of their I Capital eligible for this purpose).

Capital to Risk-weighted Assets Ratio (CRAR)

As at the end of March 2001, 23 out of the 27 Public Sector banks had capital in excess of 10% risk-weighted assets. Among the remaining, 2 had the ratio between 9 and 10%, one between 4% and 9% and one had negative CRAR.

Amongst the 23 old private sector banks, 16 had CRAR in excess of 10%, four between 9 and 10%, one between 4 and 9%, while 2 had negative CRAR. Amongst the new private sector banks only 1 had CRAR between 9% and 10% while the other 7 banks had CRAR in excess of 10%

5.7 THE PROBLEM OF NON-PERFORMING ASSETS

The Commercial Banks' biggest problem at present is the existence of huge amount of non-performing assets. The gross non-performing assets of Scheduled Commercial Banks increased from Rs. 60,408 crore as at end March 2000 to Rs. 63,883 crore at March end 2001. The net NPAs at these

dates were Rs. 30,073 crore and Rs. 32,468 crore respectively. All categories of banks—public sector, private sector and foreign banks face this problem. The Government of India and the Reserve Bank of India have taken various initiatives to reduce the magnitude of NPAs.

These initiatives include:

i) **Establishment of Debts Recovery Tribunals**

After the enactment of the Recovery of Debts due to Banks and Financial Institutions Act 1993, twenty-three Debt Recovery Tribunals have been established at various places in India. These Tribunals ensure expeditious adjudication and recovery of debts due to banks and financial institutions. Recently, these Tribunals have been granted more powers for this purpose. These Tribunals deal with claims of banks exceeding Rs. 10 lakhs each.

ii) **Proposed Establishment of Asset Reconstruction Companies**

Government has issued an ordinance in June 2002 permitting the setting up of Asset Reconstruction Companies. These companies will take over the non-performing assets from banks and financial institutions and will try to realise hem as soon as possible.

Check Your Progress 3

1) Fill up in the blanks:

   i) RBI has laid down that .... per cent of the net bank credit should be advanced to weaker section.

   ii) The foreign banks are obliged to provide............ per cent of the net banks credit to priority sector advances.

2) Identify the circumstances in which an asset is treated as non-performing asset.

   ....

   ....

   ....

5.8 LET US SUM UP

Major portion of commercial banking in India is undertaken in the public sector. Within the public sector, the State Bank of India and its subsidiaries constitute State Bank Group on the basis of their ownership pattern. New private sector banks include ICICI Bank Ltd, which is the second biggest bank after State Bank of India. Banks get the status of Scheduled Banks on the fulfilment of prescribed conditions.

The main sources of banks' funds are deposits. Interest Rates on deposits are now completely deregulated (except savings). Borrowings from Reserve Bank and other institutions also augment their funds.

Commercial Banks employ their funds in liquid assets, semi-liquid assets and profit earning assets like loans and advances. They are required to maintain a prescribed percentage of deposits with Reserve Bank of India as CRR and also to maintain Statutory Liquidity Ratio of 25%.

Funds are lent for diversified purposes—priority sector advances constitute over 40% of total advances. They also lend for housing, consumer durables, real estate financing and other personal purposes also.

Reserve Bank of India has prescribed prudential norms to be followed by the commercial banks. Capital Adequacy Norm of 9% is to be fulfilled by them.

The biggest problem of Commercial Banks presently is the existence of huge amount of non-performing assets. Efforts are being made to solve it through Debt Recovery Tribunals and otherwise also. Banking Sector Reforms have been undertaken since 1991, still further reforms are needed to improve the functioning of commercial banks.

5.9 KEY WORDS

Authorised Capital : Authorised Capital of a company is the maximum amount of capital, which it is authorised to raise from shareholders. It is fixed at the time the companies incorporated and is specified in its Memorandum of Association.

Capital to Risk-weighted Assets Ratio : According to Capital Adequacy norms, banks have to maintain capital (as defined in the norms) at a certain percentage of the risk-adjusted values of their assets. This ratio at present is 9% and is called Capital to Risk-Weighted Asset Ratio (CRAR).

Hybrid Debt Capital Instrument : Those debt instruments which have some characteristic of equity also are called Hybrid Debt Capital Instrument.

Intangible Assets : Certain assets which do not exist in physical form are called intangible assets, e.g. goodwill, patents, rights etc. Other assets are called Tangible Assets.

Paid-up Capital : Paid-up Capital is that amount of capital, which the shareholders of a company have actually paid. Companies generally issue a part of the authorised capital, which is called, issued capital. Out of this, the capital actually subscribed to by the shareholders is called subscribed capital and the actual amount paid by them is called Paid-up Capital.

Preference Shares : Preference shares refer to the shares paid prior to the equity shares in the event of dissolution of a company. They carry at a rate of dividend, which must be paid to them before any dividend is declared to equity shareholder.

Prime Lending Rate : Prime Lending Rate is the rate of interest which a commercial bank charges on its advances to a first rate borrower, i.e. the most credit worthy borrower. This is the minimum rate that banks determine individually.

Risk Weighted Assets: According to the Capital Adequacy norms laid down by Reserve Bank of India, bank assets are assigned different risk-weights according to the degree of risk involved therein. These risks weights are from 0 to 100. Thus, the risk adjusted values of assets is calculated.

Standard Assets : According to Reserve Banks's directives, banks are required to classify their assets into 4 categories. Standard Assets are those assets, which are not non-performing, i.e. banks recover interest and principal amount from the borrower regularly.

Statutory Reserve Fund : Banking Regulation Act, 1949 requires every banking company to transfer at least 20% of the projects to a reserve fund every year. This fund is called Statutory Reserve Fund.

Tenor Linked PLR : Banks are permitted by Reserve Bank of India to fix different Prime

Lending Rates for advances of different maturities. Such rates are called Tenor Linked PLR.

5.10 SOME USEFUL BOOKS

Bhole, L.M. (2000): *Financial Institutions and Markets*. Tata Mc Graw Hills, New Delhi.

Machiraju, H.R. (1998): *Indian Financial System*, Vikas Publications, Delhi.

Sundharam, K.D.S. and Varshney, P.N. (2000) – *Banking and Financial System*, Sultan Chand & Sons, Delhi.

Varshney, P.N. (1999): *Indian Financial System and Commercial Banking*, Sultan Chand & Sons, Delhi.

5.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Broadly Commercial Banks are categorised into two groups: (i) Public Sector Banks (ii) Private Sector Banks. Again, Public Sector Banks are subdivided into two categories: (i) State Bank of India, (ii) Nationalised Banks.

2) (i) 3 (ii) 8 (iii) 19 (iv) ICICI Bank Ltd.

3) See Sub-section 5.3.3 on Scheduled Banks.

Check Your Progress 2

1) The main sources of borrowings are:

   i) Reserve Bank of India, ii) Other Banks, iii) Other institutions and agencies

2) 20%

3) i) Bills purchased

   ii) Cash credits, overdrafts and loans repayable on demand

   iii) Term loans

Check Your Progress 3

1) (i) 10% (ii) 32%

2) See Section 5.6

UNIT 6 REGULATORY FRAMEWORK FOR BANKS AND NON-BANKING FINANCE COMPANIES

Structure

6.0 Objectives
6.1 Introduction
6.2 Reserve Bank of India : Its Functions as a Central Bank
6.3 Regulations over Commercial Banks
6.4 Regulations over Co-operative Banks
6.5 Regulations over Non-Banking Finance Companies
6.6 Let Us Sum Up
6.7 Key Words
6.8 Some Useful Books
6.9 Answers/Hints to Check Your Progress

6.0 OBJECTIVES

After going through this Unit, you will be able to –

- Name the various participants in the money market,
- Identify the principal regulatory authorities for banks and non-banking finance companies,
- Explain the main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks and non-banking finance companies, and
- Describe the powers vested with Reserve Bank of India under Reserve Bank of India Act, 1934 to regulate Commercial Banks and non-banking finance companies.

6.1 INTRODUCTION

Necessity of regulatory framework for the financial system has been universally felt, primarily to safeguard the interests of a large number of savers/depositors and also to ensure proper and efficient functioning of the institutions that are part and parcel of the financial system. We have, in India, two principal regulatory authorities, namely, the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). They are entrusted with the responsibilities of development and regulation of the money market and capital market respectively. These regulators derive their powers from various legislative enactments and exercise their discretion as well. The financial system thus functions within the regulatory framework. The objective of this and the next Units are to give you a broad account of such

regulatory framework. In this Unit, we shall deal with the regulatory environment for the money market and the participants therein, i.e. the Commercial Banks, the Co-operative Banks, financial institutions and the non-banking finance companies.

6.2 RESERVE BANK OF INDIA : ITS FUNCTIONS AS A CENTRAL BANK

Reserve Bank of India, besides being the Central Bank of the country, is the principal regulatory authority in the Indian money market. It derives its powers from two principal enactments, namely the Reserve Bank of India Act, 1934 and the Banking Regulations act, 1949. The Reserve Bank of India Act, 1934, apart from providing for the Constitution management and functions of the RBI, also empowers it to exercise control and regulations over the Commercial Banks, the non-banking finance companies and the financial institutions. The Banking Regulation Act 1949 contains various provisions governing the Commercial Banks in India. Many of these provisions are also applicable to the Co-operative Banks. The State Bank of India, its subsidiary banks and the nationalised banks are also governed by the status under which they have been incorporated. In the subsequent sections of this Unit, we shall deal with the regulatory framework.

First, we shall discuss the main functions performed by the Reserve Bank of India. The Reserve Bank of India was established on April 1, 1935 under the Reserve Bank of India Act, 1934. As the country's Central Bank, the Reserve Bank of India performs the following function:

a) **Issuer of Currency Notes:** Reserve Bank of India is the sole authority to issue currency notes, except one-rupee note and coins of smaller denominations. Within the RBI, all functions relating to the issuance of notes are undertaken by the **'Issue Department'**, which is responsible for issue of notes and the maintenance of eligible assets of equivalent value to back the notes issued.

b) **Banker to the Government:** RBI acts as banker to the Central Government under the Reserve Bank of India Act, and to the State Governments, under agreements with them. As the banker to the Government, RBI provides services, such as acceptance of deposits, withdrawal of funds, receipts and payments on behalf of the Government, transfer of funds and the management of public debt.

c) **Banker's Bank:** The Reserve Bank of India controls the volume of resources at the disposal of the Commercial Banks through the various measures of credit control. This checks

the ability of banks to create/squeeze credit to the industry, trade and commerce.

d) **Supervisory Authority:** RBI has the powers to supervise and control Commercial Banks. It issues licenses for starting new banks and for opening new branches. It has the power to vary the reserve ratios, to inspect the working of banks, and to approve the appointment of Chairman and Chief Executive Officers of the banks.

e) **Exchange Control Authority:** The Reserve Bank of India regulates the demands for foreign exchange in terms of the Foreign Exchange Management Act, besides maintaining the external value of Indian rupee.

f) **Regulation of Credit:** One of the most important functions of the Reserve Bank of India is to regulate the flow of credit to industry. This is achieved by measures such as the Bank rate, Reserve Requirements, Open Market Operations, selective credit controls and moral suasion.

6.3 REGULATIONS OVER COMMERCIAL BANKS

Main provisions of the Banking Regulation Act, 1949, which govern the Commercial Banks, are as follows:

1) **Establishment**

It is essential for every banking company—Indian or foreign, to acquire a licence from the Reserve Bank of India, before it commences its business in India. Reserve Bank of India issues a licence, if it is satisfied that the company fulfils the following conditions:

i) the company is/or will be in a position to pay its present or future depositors in full as their claims accrue,

ii) the affairs of the company are not being, or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors,

iii) the general character of the proposed management of the company will not be prejudicial to the public interest, or the interests, of its depositors,

iv) the company has adequate capital structure and earning prospects,

v) public interest will be served by the grant of a licence to the company to carry on banking business in India,

vi) the grant of licence would not be prejudicial to the operation

and consolidation of the banking system consistent with monetary stability and economic growth, and

vii) any other condition to ensure that the carrying on of the banking business in India by the company will not be prejudicial to the public interest or the interests of the depositors.

A foreign bank must, in addition, satisfy the following conditions:

i) the carrying on of banking business by such company in India will be in the public interest,

ii) the Government or the law of the country in which it is incorporated does not discriminate in any way against banking companies in India, and

iii) the company complies with all the provisions of the Act applicable to such companies.

2) Opening of Branches

Every banking company (Indian as well as foreign) is required to take Reserve Bank's prior permission for opening a new place of business in India or outside India, or to change the location of an existing place of business in India or outside. Reserve Bank, before granting its permission, takes into account –

i) the financial condition and history of the company,

ii) the general character of its management,

iii) the adequacy of its capital structure and earning prospects, and

iv) whether public interest will be served by the opening/ change of location of the place of business.

3) Business Permitted and Prohibited

Section 6 contains a list of businesses which may be undertaken by a banking company. Under Clause 'O', any other business may also be specified by the Central Government as the lawful business of a banking company.

But, a banking company is prohibited from undertaking, directly or indirectly, trading activities and trading risks (except for the realisation of the amount lent or in connection with the realisation of bills for collection/negotiations).

4) Subsidiary Company

A banking company may establish a subsidiary company for undertaking any business permitted under Section 6, or for

carrying on the business of banking exclusively outside India, or for undertaking any other business, which in the opinion of Reserve Bank, would be conducive to the spread of banking in India or to be useful in public interest.

5) **Paid-up Capital**

The Act stipulates the minimum aggregate value of its paid-up capital and reserves for banks established before 1962. Minimum amount of capital was raised to Rs. 5 Lakhs for banks set up after 1962. The revised guidelines issued by Reserve Bank for establishing new private sector banks prescribed minimum paid-up capital for such bank at Rs. 200 crore, which shall be increased to Rs. 300 crore in the next three years, out of which promoter's contribution will be 25% (or 20% in case paid-up capidal exceeds Rs. 100 crore). Non-Resident Indians may participate in the equity of a new bank to the extent of 40%.

The authorised capital of a nationalised bank is Rs. 1500 crore, which may be raised to Rs. 3000 crores. These banks are allowed to reduce the capital also but nor below Rs. 1500 crore. These banks are permitted to issue shares to the public also, but the share of the Central Government is not allowed to be less than 51% of the paid-up capital. The paid-up capital may be reduced at any time so as to render it below 25% of the paid-up capital as on 1995.

6) **Maintenance of Liquid Assets**

Section 24 required every banking company to maintain in India in cash, gold or unencumbered approved securities an amount which shall not, at the close of business on any day, be less than 25% of the total of its net demand and time liabilities in India. Reserve Bank of India is empowered to step up this ratio, called **Statutory Liquid Ratio (SLR)**, upto 40% of the net demand and time liabilities. When this ratio is raised, banks are compelled to keep larger proportion of their deposits in these specified liquid assets.

SLR is to be maintained on a daily basis. The amount of SLR is calculated on the basis of net demand and time liabilities as on the last Friday of the second preceding fortnight. Reserve Bank also possesses the power to decide the mode of valuation of the securities held by banks, i.e. valuation may be with reference to cost price, market price, book value or face value as may be decided by Reserve Bank of India from time to time.

Approved securities mean the securities in which the trustees may invest trust funds under **Section 20** of the Indian Trusts Act 1882. The securities should be unencumbered i.e. free of charge in favour of any creditor.

The Act also provides for penalties for default in maintaining the liquid assets under **Section 24**. At present SLR is to be maintained @ 25% of net demand and time liabilities (which excludes net inter bank liabilities).

7) Maintenance of Assets in India

Section 25 requires that the assets of every banking company in India at the close of business on the last Friday of every quarter shall not be less than 75% of its demand and time liabilities.

8) Inspection by Reserve Bank

Under Section 35, the Reserve Bank may, either at its own initiative or at the instance of the Central Government, cause an inspection to be made by one or more of the officers, of any banking company and its books and accounts. If, on the basis of the inspection report submitted by the Reserve Bank, the Central Government is of the opinion that the affairs of the banking company are conducted to detriment the interests of its depositors, it may prohibit the banking company from receiving fresh deposits or direct the Reserve Bank to apply for the winding up of banking company.

9) Reserve Bank's Power to Issue Directions

Reserve Bank of India is vested with wide powers under **Section 35** A to issue direction to banking companies generally, or to any banking company, in particular:

i) in the public interest or in the interest of banking policy, or

ii) to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company, or

iii) to secure proper management of any banking company generally.

The banking company shall be bound to comply with such directions.

Section 36 empowers the Reserve Bank to caution or prohibit banking companies against entering into any particular transaction or class of transactions and generally give advice to the banking company.

Reserve Bank also possesses the powers to ask the banking company to call a meeting of Board of Directors, to depute its officers, to watch the proceedings of the meetings of the Board, to appoint its officers as observers and to require the

banking company to make changes in the management on suggested lines.

10) **Management of Banks**

The constitution of the Board of Directors of the private sector commercial banks must be in accordance with the provisions of the Banking Regulation Act, 1949. **Section 10 A** lays down the Board of Directors be constituted in such a way that not less than 51% of the total number of members shall consist of persons who satisfy the following two conditions:

i) they have special knowledge or practical experience in respect of accountancy, agriculture, rural economy, banking, co-operation, economics, finance, law, small scale industry, or any other related matter.

ii) they do not have substantial interest in, or be connected with any company or firm which carries on any trading, commercial or industrial concern (this excludes those connected with small-scale industries or companies registered under Section 25 of the Companies Act).

Reserve Bank of India has conferred the power to direct a banking company to reconstitute the Board, if it is not constituted as above. It may remove a Director and appoint a suitable director also. A person cannot be a Director of two banking companies or a Director of a banking company, if he is a Director of companies which are entitled to exercises voting rights in excess of 25% of the total voting rights of all shareholders of the banking company.

The Act also requires that the Chairman of a banking company shall be a person who has special knowledge and practical experience of the working of a bank or financial institution, or that of financial, economic or business administration. But he shall not be a Director of a company, partner in a firm or have substantial interest in any company or firm. If, the Reserve Bank of India is of the opinion that a person appointed as Chairman is not a fit/proper person to hold such office, it may request the bank to elect another person. If it fails to do so, the Reserve Bank of India is authorised to remove the said person and to appoint a suitable person in his place.

Reserve Bank's approval is also required to appoint, re-appoint, or terminate the appointment of a Chairman, Director, or Chief Executive Officer. Reserve Bank has the power to remove top managerial personnel of the banking companies, if the Bank feels it necessary in the public interest, or for preventing the affairs of a banking company being conducted in a manner detrimental to the interests of the depositors. Reserve Bank may appoint a suitable person in place of the person so

removed. Moreover, Reserve Bank is also empowered to appoint Additional Directors not exceeding five or one third of the maximum strength of the Board, whichever is less.

The Board of Directors of the nationalised banks, are to be constituted in accordance with the provisions of Section 9 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or 1980. It provides for appointment as Directors or officials of RBI, Central Government, other financial institutions and from amongst the officers and workmen of the bank concerned. Moreover, six Directors are to be nominated by the Central Government, and two to six directors are to be elected by shareholders other than Central Government. These Directors are required to be experts in, or have practical experience in the subjects enumerated above in case of private banks' Directors. If the Reserve Bank is of the opinion that any Director elected by the shareholders (other than Government) does not fulfil the aforesaid requirement, it can remove such Director, and the Board of Directors shall co-opt another person in his place.

The nationalised banks are under an obligation to comply with the guidance given by the Central Government. According to **Section 8** of the (Nationalisation) Act, "every nationalised bank shall, in the discharge of its functions, be guided by such directions in regard to matters of policy, involving public interest as the Central Government may, after consultation with the Governor of the Reserve Bank, give".

11) **Control over Advances**

Section 21 confers wide powers on the Reserve Bank of India to issue directive to the banking companies with regard to the advances to be granted by the banking companies either generally or by any of them in particular. These directions may relate to any or all of the following:

a) the purposes for which advances may, or may not be, granted,

b) the margins to be maintained in respect of secured advances,

c) the maximum amount of advance to any one company, firm, individual or association of persons,

d) the maximum amount upto which guarantees may be given by the banking company on behalf of any company or firm, and

e) the rate of interest and other terms and conditions, on which advances may be made or guarantees may be given.

The directive issued under this Section is called **Selective**

Credit Control Directives, if they relate to advances on the security of selected commodities. Banks are bound to comply with these directives.

12) **Restrictions on Loans and Advances**

A banking company is prohibited from sanctioning loans and advances on the security of its own shares. Restrictions are also imposed under **Section 20** on the loans granted by banks to the persons interested in the management of banks.

13) **Maintenance of Cash Reserve with Reserve Bank**

Section 42 of the Reserve Bank Act, 1934 requires every scheduled bank to maintain with the Reserve Bank of India an average daily balance, the amount of which shall not be less than 3% of the net demand and time liabilities of the bank in India. Reserve Bank of India is empowered to increase this rate upto 20% of the net demand and time liabilities. If a bank fails to maintain the cash balance as required by the Reserve Bank, penalty may be imposed as prescribed in the Act. This provision applies to all scheduled banks, commercial banks, state co-operative banks, and Regional Rural Banks.

With effect from December 29, 2001, commercial banks are required to maintain Cash Reserve Ratio @ 5.5% of their net demand and time liabilities of the second preceding fortnight. It was reduced by 2 percentage points from 7.5% to 5.5% with effect from that date and further to 5% w.e.f. June 1, 2002. Reserve Bank of India pays interest on eligible cash reserves as per the Bank Rate (6.5%).

6.4 REGULATIONS OVER COOPERATIVE BANKS

The category of co-operative banks comprises of the central and state co-operative banks and urban co-operative banks. They are organised co-operative societies, which are registered and governed by State Governments under the respective Cooperative Societies Act. Thus, matters relating to registration, administration, recruitments, liquidation and amalgamation are controlled by State Governments. As they perform the functions of a bank, certain provisions of the Banking Regulation Act, 1949 also apply to them. Thus, they are regulated by Reserve Bank of India so far as matters relating to banking are concerned.

Reserve Bank's supervision and control over urban co-operative banks is far weaker. They are subject to dual control, which remains a problem. Reserve Bank has, however, prescribed prudential norms relating to income recognition, asset classification and provisioning. Exposure

norms, similar to commercial banks, have also been prescribed for urban co-operative banks.

Check Your Progress 1

1) List the factors which are taken into consideration by Reserve Bank of India while permitting banking company to open a new place of business.

....

....

2) Fill in the blanks:

   i) The authorised capital of a nationalised bank is ....

   ii) Reserve Bank of India is empowered to raise the Statutory Liquidity Ratio (SLR) upto the extent of .... of net demand and time liabilities.

   iii) Section .... empowers RBI to issue directives to banking companies.

   iv) Cash Reserve Ratio is an important instrument of ....

3) Which functions are performed by the RBI?

....

....

6.5 REGULATIONS OVER NON-BANKING FINANCE COMPANIES

The Non-Banking Finance Companies perform very important financial intermediation function in India. They supplement the role of the banking institutions, as they cater to the needs of those borrowers who remain beyond the purview of the banking institutions and mobilise the savings from the depositors. Hire purchase finance and leasing companies, loans and investment companies and housing finance companies are the important categories of such Non-Banking Finance Companies (NBFCs).

In view of the significant role played by NBFCs, regulatory framework has been devised, particularly to safeguard the interests of the depositors. Chapter III B of the Reserve Bank of India Act, 1934 provides for such regulatory framework over NBFCs. Significant amendments to this Chapter were made in January, 1997, vesting more powers in the Reserve Bank of India to regulate the activities of such companies. We shall first deal with the provisions of Chapter III B, following by the important provisions of the directives issued by the Reserve Bank of India in this regard.

1) **Reserve Bank of India Act, 1934**

The powers vested in the Reserve Bank of India Act under Chapter III B of Reserve Bank of India Act, 1934 are as follows:

i) **To regulate or prohibit issue of prospectus**

In the public interest, the Reserve Bank of India may regulate or prohibit the issue by any non-banking company of any prospectus or advertisement soliciting deposits of money from the public. The Bank may also give directions to these companies as to the particulars to be included in such advertisements.

ii) **To collect information as to deposits and to give direction**

The Reserve Bank of India is empowered to direct every non-banking institution to furnish to it information or particulars relating to the deposits received by it. The Bank may also issue directions in the public interest, to such institutions generally, or to any institution in particular, or group of such institutions in particular, on any of the matters connected with the receipt of deposits. If any such institution fails to comply with any direction, the Bank may prohibit the acceptance of deposits by such institutions.

iii) **To conduct inspection**

The Reserve Bank of India may, at any time, cause an inspection to be made of any non-banking institution to verify the correctness/completeness of the particulars furnished to the Bank or to obtain any such particulars, if not submitted.

iv) The Reserve Bank of India (Amendment) Act, 1997, has conferred explicit powers on the Reserve Bank of India as follows:

a) A new NBFC cannot operate unless it is registered with Reserve Bank of India and has a minimum owned funds of Rs. 25 lakhs. Reserve Bank has been vested with the power of enhancing the minimum Net Owned Funds (NOF) of NBFCs to Rs. 2 crore in case of companies which are incorporated on or after April 20, 1999, and which seek registration with Reserve Bank of India.

b) Every NBFC is required to create a Reserve Fund and transfer not less than 20% of its net profit each year to such fund before declaring any dividend.

c) Reserve Bank of India is given the power to prescribe the minimum level of liquid assets, as a percentage of the deposits, to be maintained in unencumbered approved securities (i.e. government securities/guaranteed bonds).

d) The Company Law Board has been empowered to direct NBFCs to repay deposits that have matured, if it finds that the company is unable or unwilling to repay the depositors.

e) Powers have been conferred upon the Reserve Bank of India to:

- give directions to the NBFCs regarding prudential norms,
- give directions to the NBFCs and their auditors on matters relating to balance sheets and cause special audit as well as to impose penalty on erring auditors,
- prohibit NBFCs from accepting deposits for violation of the provisions of the RBI Act and to direct NBFCs not to alienate their assets,
- file winding up petition against erring NBFCs,
- impose penalty directly on the erring NBFCs.

2) **NBFCs Acceptance of Public Deposits (Reserve Bank) Directions**

In exercise of the powers vested in it under Chapter III B, the Reserve Bank of India, issued these directions to NBFCs regarding acceptance of deposits from the public. These directions were substantially revised in January, 1998 to include prudential norms to be followed by NBFCs. The salient features of RBI Directions, as further revised in December, 1998 are as follows:

i) For regulatory purposes, NBFCs have been classified into three categories:

a) those accepting public deposits,

b) those not accepting public deposits, but engaged in financial business ,

c) core investment companies, with 90% of their total assets in investments in the securities of their group/holding/ subsidiary companies.

The thrust of RBI regulation is on companies accepting public deposits (category (a) above).

ii) Public deposits have been defined to include fixed/recurring deposits received from public, deposits received from relatives and friends, deposits from shareholders by a public limited company and money raised by issue of unsecured debentures and bonds to shareholders and the public. Public Deposits exclude money raised by way of issue of secured debentures and bonds, borrowings from banks and financial institutions (including by way of unsecured debentures), deposits from directors, inter-corporate deposits, deposits from foreign citizens, deposits received

by private limited companies from their shareholders, security deposits from employees, advance receipt of lease and hire purchase instalments.

iii) NBFCs with net owned funds (NOF) of less than Rs. 25 lakh (with or without credit rating) are not allowed to accept public deposits.

iv) Ceilings on public deposits for NBFCs, with NOF of Rs. 25 lakh and above, have been prescribed as follows. These ceiling limits were enforced in December, 1998. Prior to that, these limits were based on the credit rating (effective January, 1998).

A) **Equipment Leasing and Hire Purchase Finance Companies**

a) for unrated and under-rated (i.e. rating below the minimum investment grade) NBFCs—1.5 times of their NOF or Rs. 10 crore, whichever is less (provided their CRAR is 15%, or above, as per their last audited balance sheet).

b) for NBFCs with minimum investment grade credit rating—4 times of their NOF (provided they have CRAR of not less than 10% as on 31.3.1998 and not less than 12% as on 31.3.1999). They are required to increase CRAR to 15% as early as possible.

B) **Loan and Investment Companies**

a) unrated and under-rated—not entitled to accept public deposits (irrespective of their NOF and CRAR).

b) with minimum Investment Grade Credit Rating—1.5 times of NOF (provided they have CRAR of 15% or above).

Further, it has been stipulated that loan and investment companies which do not have minimum CRAR of 15% as on date, but otherwise comply with all the prudential norms and

a) have credit rating of AAA may accept or renew public deposits upto the level outstanding as on December 18, 1998 or 1.5 times of the NOF whichever is more, subject to the condition that they should attain CRAR or 15% by 31st March, 2000 and bring down the excess deposits, if any, by December 31, 2000, and

b) have credit rating of AA/A may accept or renew public deposits as per the existing provisions of Directions (i.e. 0.5 or 1 time of their NOF), but they should attain the minimum CRAR of 15% on or before 31st March, 2000 as per their audited balance sheet, failing which they should regularise their position by repayment or otherwise by December 31, 2001.

The above benefit will not be available to those companies whose CRAR is presently 15% and above but slips down below the minimum level of 15% subsequently.

v) The maximum permissible interest rate on public deposits has been fixed at 16% per annum. NBFCs can pay uniform maximum brokerage of 2% on deposits for 1 year to 5 years. Brokers may also be reimbursed other expenses not exceeding 0.5% of the collected deposits.

vi) Only those NBFCs, which are accepting public deposits, are required to submit to Reserve Bank annual statutory returns and financial statements. Other NBFCs are exempted from this requirement.

3) **Prudential Norms for NBFCs**

Reserve Bank of India issued guidelines prescribing the prudential norms for NBFCs in June, 1994. Companies accepting public deposits have to comply with all the guidelines, while leasing, hire purchase finance, loan and investment companies, not accepting public deposits, are required to comply with prudential norms other norms on capital adequacy and credit/investment concentration. Similarly, investment companies holding not less than 90% of their assets being securities of their group/holding/subsidiary companies and not accepting public deposits are exempted from prudential norms. These guidelines are as follows:

i) **Income Recognition**

NBFCs are required not to take into books income due but not received within a period of six months, till it is actually received.

ii) **Classification of Assets**

NBFCs are required to classify their assets as non-performing assets if payment of principal/instalment is due but not received within six months. For leasing, hire purchase finance companies such assets are to be treated as NPAs, if lease rentals and hire purchase instalments remain past due for 12 months. Guidelines regarding classification of assets into 4 categories and provisioning issued to commercial banks, are applicable to NBFCs also.

iii) **Capital Adequacy Norm**

In January 1998, the capital adequacy requirement for NBFCs with net owned funds of Rs. 25 lakhs and above and having public deposits had been raised from 8% to 10% (effective 31.3.1998), and further to 12% (effective 31.3.1999). The composition of capital and risk weights attached to assets and conversion of off Balance Sheet items are the same as applicable to banks.

iv) **Credit/Investment Concentration Norms**

Registered finance companies are required not to lend more than 15% of their net owned funds to a single borrower and not more than 25% of their owned funds to a group of borrowers. These limits are also applicable to investment in a single company or a single group of companies. Composite limits of credit to and investment in a single company or a single group of companies have been prescribed at 25% and 40% respectively of its owned funds. NBFCs are not permitted to lend on the security of their own shares.

The ceiling on investment in unquoted shares of companies other than their group/subsidiary companies has been fixed at 10% of their owned funds for equipment leasing and hire purchase finance companies and 20% of the owned funds for loan and investment companies.

NBFCs are advised not to invest more than 10% of their owned funds in land and building except for their own use.

NBFCs are requied to dispose off excess of the assets over the indicated ceilings within three years.

v) **Liquid Assets**

NBFCs are required to maintain certain percentage of their deposits in liquid assets to ensure their liquidity and to safeguard the interests of the depositors. With effect from January 2, 1998, the ratio of liquid assets is uniform for all NBFCs accepting public deposits. It has been prescribed at 12.5% with effect from April 1, 1998 and at 15% with effect from April 1, 1999. The liquid assets are to be maintained with relation to public deposits only.

NBFCs are required to keep Government securities and Government guaranteed bonds in the custody of a scheduled bank at the place of its head office. These securities are permitted to be withdrawn for repayment to depositors or for replacing them by other securities or in the case of reduction of deposits.

The above account shows that the Reserve Bank of India has instituted a comprehensive regulatory framework for NBFCs. Out of 8802 applications of NBFCs which were eligible for registration on the basis of Minimum Net Owned Funds of Rs. 25 lakh, registration has been granted to 7555 NBFCs. Out of them only 584 NBFCs have been permitted to accept public deposits. Applications of 1030 companies have been rejected. 28676 companies with NOF below Rs. 25 lakh have been given time upto January 8, 2000 to achieve the minimum NOF. Thus, an era of consolidating and strengthening the Non-Banking Financial Companies has commenced and better results may be expected in future.

Check Your Progress 2

1) Identify the powers vested in RBI under Chapter 3, III B of RBI Act 1934.

....

....

2) State whether following statements are true or false:

   i) NBFCs with owned fund of less than Rs. 25 lakh are not allowed to accept public deposits. (T/F)

   ii) For regulatory purpose NBFCs have been classified into four categories. (T/F)

   iii) Unrated and under-rated loan and investment companies are not entitled to accept public deposits. (T/F)

   iv) NBFCs are advised not to invest more than 10% of their owned funds in Land and building except for their own use. (T/F)

3) Are Non-Banking Finance Companies required to observe capital adequacy and credit/investment concentration norms? Why?

....

....

6.6 LET US SUM UP

In this Unit we have studied the regulatory framework under which the banks and non-banking finance companies in India function. There are two regulatory authorities in this field, viz. the Reserve Bank of India and the Securities and Exchange Board of India. They have been entrusted with the responsibilities of development and regulation of the money market and capital market respectively.

The Reserve Bank of India is the regulatory authority over the commercial banks, co-operative banks, non-banking finance companies and the financial institutions. It derives its powers from the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949. Exercising its discretionary powers, the Reserve Bank of India issues directives to these institutions from time to time. In this Unit, we have studied institution-wise regulatory framework.

Reserve Bank exercises control over the commercial banks through the provisions of the Banking Regulation Act, 1949, relating to licensing of banks, opening of branches, establishment of subsidiaries, paid-up capital, maintenance of liquid assets. Reserve Bank of India has the power to

inspect the banks, to issue the directives, to exercise control over the top management and advances granted by them. Cash Reserves are maintained by banks with the Reserve Bank of India under Section 42 of the Reserve Bank of India Act, 1934. Reserve Bank of India has also issued directives regarding priority sector advanced, capital adequacy ratio, exposure norms, assets classification, provisioning, etc.

Co-operative Banks are under the dual control of the State Government concerned and the Reserve Bank of India. Reserve Bank of India has been vested with the powers to regulate the non-banking finance companies and the financial institutions. Directives have been issued by Reserve Bank of India to NBFCs regarding acceptance of public deposits and Prudential Norms have been prescribed for both NBFCS and financial institutions.

6.7 KEY WORDS

Call/Notice/Term Money Market : These are three sub-divisions of the money market. When funds are lent for very short-period of time, say a day or two, or are repayable on call by the lender, it is called a transaction in the call money market. Banks are generally participants in call money market.

When funds lent are repayable after a short notice or 3 or 7 days, it constitutes notice money market. When funds are lent for a fixed but short period, say 15 or 30 days, it is term money market.

Cash Reserve Ratio : Banks are required to maintain a certain percentage of their net demand and time liabilities as cash balance with Reserve Bank of India. The statutory minimum ratio is 3%, but Reserve Bank of India can raise it upto 20%. At present it is 5.0% (effective from June 1, 2002).

Capital Adequacy Norms : Reserve Bank of India has laid down this norm for banks and financial institutions to ensure that they possess adequate capital funds of their own, vis-à-vis their assets, which are adjusted for the risk involved therein.

Credit Rating : Credit Rating is a symbol assigned by Credit Rating Agency to a debt

instrument of a company like bond, debentures, fixed deposits and commercial paper, depicting the quality of the instrument in terms of safety of principal and possibilities of payment of interest etc.

Exposure Norms : These norms are also fixed by Reserve Bank of India for banks and financial institutions. These norms lay down the maximum limit on advances to be granted by a bank/non-banking company or financial institution, together with any other stake undertaken by them in respect of one single borrower and/or a group of borrowers. This norm is expressed as a percentage of the net-owned funds of the bank/FI. Such norm is also laid down by a bank's exposure in a single industry. Its purpose is to restrict the banks from over-lending to a single borrower/group of borrowers.

Liquid Assets : Banks maintain a certain portion of their deposits in cash with themselves or in current account with other banks or with Reserve Bank of India. Besides, they invest in gilt, edged securities also which can be converted in cash easily. Such assets of a bank are called liquid assets.

Money Market : Money Market is that segment of the financial market wherein transactions in short-term funds are undertaken, i.e. where funds are low and borrowing is for short periods.

Nationalised Banks : There are 19 Commercial Banks in India which are nationalised banks. The ownership of such banks is vested in Government of India. A few of them have in recent years issued capital to the public also.

Priority Sector : Reserve Bank of India has designated certain sectors of the economy as priority sectors. Banks have been asked to provide at least 40% of their credit to these sectors. These sectors

include small industries, export, small business and small transporters and self-employed persons and so on. These sectors had remained neglected by the banks in the past.

Prudential Norms : To improve the financial position of the banks and their efficiency and productivity, Reserve Bank of India has prescribed certain norms (i.e. principles or standards) to be followed by banks. These norms are called prudential norms as they are intended to lead to prudential practices.

Repo and Reverse Repo Deals : Repo means repurchase. A person or institution may borrow money for a short period on repo basis also. It means that he sells to the lender his securities with the condition that he may buy back his securities within a certain period and repay the amount of the loan taken/sale proceeds of the security. In such case, he will pay interest for the period for which he has utilised the money. It is called 'repo rate'.

'Reverse repo' is opposite to 'Repo'. In this case the lender lends the money (or purchases the securities) on the condition that he may sell the securities back to the same person, who shall take them back and pay the 'reverse repo' rate to the lender.

Selective Credit Control : Reserve Bank of India has the power to issue directives to the banks determining the amounts, terms and conditions, the rate of interest etc. on advances granted on the security of selected commodities. Such directives are called selective credit control directives.

Statutory Liquid Ratio (SLR) : Reserve Bank of India prescribes a ratio of liquid assets to net demand and time liabilities of a bank. Such ratio is called SLR. At present it is 25% (i.e. minimum prescribed by law).

6.8 SOME USEFUL BOOKS

Bhole, L.M. (2000) –*Financial Institutions and Markets,* Tata McGraw Hills, New Delhi.

Khan, M. (2000) –*Financial Services,* Chapter 1.

Machiraju, H.R.(1998)–*Indian Financial System,* Vikas Publishing House, Delhi

Reserve Bank of India–*Functions and Working* (1983), RBI.

Reserve Bank of India–*Various Reports on Currency and Finance.*

Varshney, P.N. (1999)–*Indian Financial System and Commercial Banking,* Sultan Chand & Sons, Delhi.

Varshney, P.N. & Mittal, D.K., 4th Edition (2002) - *Indian Financial System,* Sultan Chand & Sons, Delhi.

6.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) i) The financial condition and history of the company.

   ii) The general characteristics of its management.

   iii) The adequacy of its capital structure and earning prospects.

   iv) Impact on public interest.

2) (i) Rs. 1500 crore (ii) 20% (iii) Section 35 A
   (iv) Credit Control

3) See Section 6.2

Check Your Progress 2

1) i) Regulation of issue of prospectus.

   ii) Collection of information relating to deposits received by any NBFC.

   iii) Conducting of inspection of any NBFC to verify correctness/completeness of the particulars furnished to the bank.

2) (i) True (ii) False (iii) True (iv) True

3) See Section 6.5

UNIT 7 MONEY MARKET IN INDIA

Structure

7.0 Objectives
7.1 Introduction
7.2 Participants in Money Market
7.3 Reserve Bank of India
7.3.1 Interim Liquidity Adjustment Facility
7.3.2 Liquidity Adjustment Facility
7.4 Money at Call and Short Notice
7.4.1 Move towards Pure Inter Bank Call Money Market
7.5 Treasury Bills
7.5.1 Discount and Finance House of India and Treasury Bills
7.5.2 Commercial Bills of Exchange
7.6 Certificates of Deposits
7.7 Commercial Paper
7.8 Let Us Sum Up
7.9 Key Words
7.10 Some Useful Books
7.11 Answers/Hints to Check Your Progress

7.0 OBJECTIVES

This unit deals with the money market in India—its participants and instruments. After going through this Unit, you will be able to -

- Explain the meaning and significance of the money market,
- Describe nature and mechanism of various instruments used in the money market, and
- Discuss role of the regulator—Reserve Bank of India, over the money market.

7.1 INTRODUCTION

We have learned in the previous Units that the financial market plays a very important role in the economy of a country. These markets are broadly classified into two categories namely, Money Market and Capital Market, primarily based on the duration for which dealing in funds are transacted. In this Unit, we will discuss the money market in India. The Capital Market will be taken up in the next Unit. Money Market is the market for short-term funds, generally ranging from overnight to a year. It helps in meeting the short-term and very short-term requirements of banks, financial institutions, firms, companies and also the Government. On the other hand, the surplus funds for short periods, with the individuals and other savers, are mobilised through the market and made available to the

aforesaid entities for utilisation by them. Thus, the money market provides a mechanism for evening out short-term liquidity imbalances within an economy. The development of the money market is, thus, a prerequisite for the growth and development of the economy of a country.

7.2 PARTICIPANTS IN MONEY MARKET

The major participants who supply the funds and demand the same in the money market are as follows:

i) **Reserve Bank of India:** Reserve Bank of India is the regulator over the money market in India. As the Central Bank, it injects liquidity in the banking system, when it is deficient and contracts the same in opposite situation.

ii) **Banks:** Commercial Banks and the Co-operative Banks are the major participants in the Indian money market. They mobilise the savings of the people through acceptance of deposits and lend it to business houses for their short-term working capital requirements. While a portion of these deposits is invested in medium and long-term Government securities and corporate shares and bonds, they provide short-term funds to the Government by investing in the Treasury Bills. They employ the short-term surpluses in various money market instruments.

iii) **Discount and Finance House of India Ltd. (DFHI):** DFHI deals both ways in the money market instruments. Hence, it has helped in the growth of secondary market, as well as those of the money market instruments.

iv) **Financial and Investment Institutions:** These institutions (eg. LIC, UTI, GIC, Development Banks, etc.) have been allowed to participate in the call money market as lenders only.

v) **Corporates:** Companies create demand for funds from the banking system. They raise short-term funds directly from the money market by issuing commercial paper. Moreover, they accept public deposits and also indulge in inter-corporate deposits and investments.

vi) **Mutual Funds:** Mutual funds also invest their surplus funds in various money market instruments for short periods. They are also permitted to participate in the Call Money Market. Money Market Mutual Funds have been set up specifically for the purpose of mobilisation of short-term funds for investment in money market instruments.

7.3 RESERVE BANK OF INDIA

As the Central Bank of the country, the Reserve Bank of

India plays a very significant role in the Indian Money Market. The various tasks being performed by the Reserve Bank have been explained in Unit 6. Let us recall that Reserve Bank is the banker to the banks and Central and State Governments. It manages the liquidity in the money market by granting refinance facilities to the banks and by stipulating the reserve requirements. **Cash Reserve Ratio (CRR)** and **Statutory Liquidity Requirements (SLR)** are the principal tools to affect the liquidity with the banks. When the banking system has excess liquidity, Reserve Bank of India raises the **Cash Reserve Ratio (CRR)** and thus, impounds the surplus liquidity and vice-versa. Statutory Liquidity requirement is raised to divert bank funds mainly to Government and other approved securities and thereby reducing liquidity with banks.

Reserve Bank of India has been providing in the past refinance facilities to the banks through different schemes, which were in operation from time to time. The **Narsimham Committee on Banking Sector Reforms, 1998** recommended that the Reserve Bank of India should provide support to the market through a Liquidity Adjustment Facility (LAF). Reserve Bank of India accordingly introduced LAF effective from June 5, 2000, which was preceded by interim liquidity facility, w.e.f. April, 1997.

7.3.1 Interim Liquidity Adjustment Facility (ILAF)

Under the ILAF facility, liquidity was managed through a combination of:

i) Repos

ii) Export credit refinance

iii) Collateralised lending facilities

iv) Open market operations at set rate of interest

Repo is a method of borrowing against certain securities for a short period. The borrower undertakes a commitment to purchase back (or to take back) the same securities after the specified period at a pre-determined price. The difference between the two prices is treated as interest on the amount borrowed.

Reserve Repo is the opposite practice wherein the lender lends against the securities with the commitment to take back the securities from the borrower against payment at a specified price. Thus by reverse repos the Reserve Bank contracts liquidity from the system.

Collateralised Lending Facility: Under this facility, banks

were provided funds upto 0.25% of their fortnightly average outstanding aggregate deposits in 1997-98. This facility was available for two weeks at the Bank rate. An **Additional Collateralised Lending Facility (ACLF)** for an equivalent amount at the Bank rate plus 2% was also made available to banks. These funds could be utilised beyond two weeks at a penal rate of 2.0%. Similarly, Primary Dealers were provided Level I Liquidity Support (equal to CLF for banks) against **collateral of Government securities** for period upto 90 days. They were also provided Additional Level II Liquidity Support (equal to ACLF) at Bank rate plus 2% for a period up to two weeks at a time. Thus, the Reserve Bank managed liquidity under the Interim Liquidity Adjustment Facility which was later on converted into full-fledged Liquidity Adjustment Facility.

7.3.2 Liquidity Adjustment Facility (LAF)

This facility was introduced with effect from June 5, 2000 and will be completed in three phases as follows:

1) The ACLF for banks and Level II liquidity support to Primary Dealers, as stated above, have been replaced by variable reverse repo auctions. The fixed rate repo has been replaced by variable rate repo auctions.

2) In the second stage, CLF for banks and Level I support to Primary Dealers will be replaced by variable rate reverse repo auctions.

3) In the third stage the LAF will be operated at different timings of the same day, if necessary.

Thus, after the second stage, repos and reverse repos, together with open market operations, will become the main instruments of affecting liquidity in the system.

At present repo/reverse repo auctions are conducted on a daily basis except Saturdays with a tenor of one day except on Fridays and days preceding the holidays. Bids are invited by Reserve Bank of India which are accepted either wholly or partially.

Interest rates in respect of both repos and reverse repos are decided through cut off rates emerging from auctions on uniform price basis. In August 2000, repo auctions of tenor between 3 to 7 days were also introduced.

When market liquidity happens to be easy, there are heavy bids at the Reserve Bank's repos auctions. Repo rate is an overnight rate. In the beginning of March 2002, Reserve Bank of India reduced the cut off rate for one-day repo auctions from 6.5% to 6%. Thus, repo rate is considered as the floor rate for the call rates. It was further reduced to 5.75% w.e.f. 27th June, 2002.

Reserve Bank of India infuses liquidity by accepting bids at the Reverse Repo auctions. The chief advantage of the system of LAF is the quantum of adjustment and also the rates of interest would be flexible depending upon the needs of the system. Moreover, funds lent by Reserve Bank of India under this facility are intended to meet primarily the day-to-day liquidity mis-match in the system and will not be permitted to be used for meeting the normal financing requirements of the banks and other institutions.

Check Your Progress 1

1) What do you understand by Money Market? Who are the major participants in this Market?

....

....

....

2) What are the salient features and significance of the Liquidity Adjustments Facility implemented by the Reserve Bank of India?

....

....

....

3) Distinguish between:

   (i) Money Market and Capital Market

   (ii) Repos and Reverse Repos

....

....

....

7.4 MONEY AT CALL AND SHORT NOTICE

Market at call and short notice is an important constituent of the money market. It deals with short-term funds repayable at call or at a short notice. Initially the commercial banks used to be the participants in this market. Hence, this market was called the Inter Bank Call Money Market. The necessity for such inter-bank borrowings arise because some banks feel the need for short-term liquidity at a certain time, while other banks have surplus liquidity at that time which they can spare for a short period, e.g. a day or a few days, and thereby, they intend to earn income.

During the last two decades, the Reserve Bank of India has permitted other financial institutions also to participate in the Call Money Market, but only as lenders. Such institutions include the Life Insurance Corporation of India, the Unit

Trust of India, the General Insurance Corporation of India, the Industrial Development Bank of India, the National Bank for Agriculture and Rural Development, and Mutual Funds. Further, the Reserve Bank of India also permitted all such entities which have bulk lendable resources and not having outstanding borrowings from banks, to lend in the Call Money Market through Primary Dealers. The Discount and Finance House of India plays a very significant role in the Call Money Market and participates both as a lender and a borrower. Its leading role in this market may be gauzed only by the fact that its aggregate lending in the Call, Notice and Term Money Market amounted to Rs. 6,57,094 crore during 2000-01 and Rs. 6,77,922 crore during the previous year. It offers two rates–Bid Rate and Offer Rate with a small difference between the two. For example as on 29th November, 2001 its bid rate was 6.70%, while the offer rate was 6.40%.

Till May 1984 the Call rates were administered by Indian Banks' Association by imposing a ceiling rate. Since then, it is now determined by the demand for and supply of bankable funds in the market. The Call rates are very volatile in behaviour—they shoot up when there is dearth of liquidity and ease with abundant supply of funds. This is the case with the Call lending rates announced by the Discount and Finance House of India Ltd also. For example, during the year 2000-01 the minimum rate touched the level of 0.50% during the fortnight ended on 20th April 2000 and the maximum rate went up to 35% during the fortnight ended 29th June, 2000.

7.4.1 Move Towards Pure Inter-Bank Call Money Market

As we have already noted above, several non-bank entities such as financial institutions and corporates (which lend in the call money market through Primary Dealers) were permitted to lend in the call/notice money market. Accepting the recommendation of the Narasimham Committee II, Reserve Bank of India has decided to move towards a pure inter-bank (including Primary Dealers) call/notice money market. In its credit policy of April 2001, Reserve Bank of India announced the steps to gradually phase out these institutions. Permission to corporates to route their call transactions through Primary Dealers was given upto June 30, 2001. Non-bank institutions are required to gradually reduce their participation in call market in four stages. With effect from May 5, 2001 non-banks have been allowed to lend upto 85% of their average daily lending in call market during 2000-01. Their participation will be reduced to 70%, 40%, 10% and 0% of their average daily lending during 2000-01 with effect from the dates to be fixed by Reserve Bank. The exclusion of the non-banks from the call

money market is expected to reduce the volatility in the market. Instead, it is intended to develop the repo-market so that the non-banks can park their excess funds there.

In its credit policy announced on April 29, 2002, Reserve Bank of India decided to reduce banks' relance on call/ notice money market. For this purpose, the following limits have proposed:

i) **Scheduled Commercial Banks' daily lending** in the Call/ notice money market will be restricted to 25% of their owned funds as at the end of March of the previous financial year.

ii) Their daily borrowings in the call/notice money market will be restricted to 100% of their owned funds or 2% of their aggregate deposits at the end of March of the previous financial year, whichever is higher. This will be implemented by August, 2002.

7.5 TREASURY BILLS

A Treasury Bill is an instrument for short-term borrowing by the Government of India. It is issued by the Reserve Bank of India on behalf of the Government of India in the form of a promissory note. The necessity for issuing treasury bills arises because of the periodic nature of receipts of Government while the Government expenditure is on a continuing basis. Taxes are payable to the Government after quarterly intervals or so, but Government has to meet its expenditure on daily or monthly basis. Thus, to bridge this mis-match between the timings of Government receipts and expenditure, Government borrows money on short-term basis by issuing Treasury Bills.

The Treasury Bills are issued for different maturity periods. Till May 14, 2001, the maturity periods were 14 days, 91 days, 182 days and 365 days. But with effect from May 14, 2001 auctions of 14 days and 182 days Treasury Bills have been discontinued. The Treasury Bills are sold through auctions. While auctions of 91 days Treasury Bills take place on a weekly basis, the auctions for 364 days Treasury Bills are held on a fortnightly basis. The Reserve Bank of India also notifies the amounts in respect of the Treasury Bill auctions. The notified amounts for 14 days, 91 days Treasury Bills auctions are Rs. 100 crores each. The notified amount for 364 day Treasury Bills was raised from Rs. 500 crores to Rs. 750 crores during 2000-01 and has been further raised to Rs. 1000 crores for auctions to be held during 2002-03.

Out of the bids received by it, the Reserve Bank of India accepts bids upto the notified amount after determining its cut-off rate. The bids may be accepted for a lower amount also. In such cases, the rest of the amount (i.e. unsubscribe

amount) devolves on the Reserve Bank of India. On the basis of the cut-off price, a yield on the Treasury bill is calculated. For example, in the auction for 14 day Treasury Bills held on 26th Dec., 2000, 18 bids were received but only 5 were accepted for Rs. 30 crore at the cut–off price of Rs. 99.68 giving a yield of 8.37% which was equal to the yield in previous auction. Thus, Rs. 70 crores were devolved on the Reserve Bank of India. The yield on Treasury Bills depends upon the price at the cut off level. There has been significant drop in the yield on Treasury Bills in the Financial Year 2001-02 as shown in the Table below:

Table: 7.1
Yield on Treasury Bills

	364 days Bill		91 days Bill	
Month	**2000-01**	**2001-02**	**2000-01**	**2001-02**
April	9.27	8.83	8.05	8.06
May	9.15	8.33	8.46	7.65
June	9.24	7.83	8.91	7.26
July	9.77	7.37	8.86	7.07
August	10.81	7.22	10.29	6.91
September	10.85	7.21	10.17	7.01
October	10.46	7.05	9.67	6.86
November	10.15	6.75	9.08	6.71
December	10.02	7.13	8.90	6.89

Source: Economic Survey 2001-02

7.5.1 Discount and Finance House of India and Treasury Bills

Discount and Finance House of India (DFHI) was set-up by the Reserve Bank of India jointly with public sector banks and All-India Financial Institutions. It was incorporated on March 8, 1988 under the Companies Act, 1956 and commenced its business operations from April 25, 1988. The main objective of establishing DFHI was *"to facilitate the smoothening of the short-term liquidity imbalances by developing an active money market, and integrating the various segments of the money market."* DFHI has a share capital of Rs. 200 crores which has been subscribed by Reserve Bank of India, public sector banks and Financial Institutions.

The activities of DFHI include the following:

a) **Dealing in Treasury Bill:** Treasury Bills are issued by the Reserve Bank of India on behalf of the Government of India. DFHI regularly participates in the auctions through which

these Treasury bills are sold. DFHI provides a ready market for these Treasury Bills by offering buy/sell quotes.

b) **Re-discounting short-term commercial bills:** DFHI aims to impart liquidity to commercial bills, which have already been discounted by commercial banks or Financial Institutions. For this purpose, it announces its bid and re-discount rates on a fortnightly basis.

c) **Participating in the Inter-Bank call money, notice money and term deposit market:** DFHI has been permitted by the Reserve Bank of India to operate in the inter-bank call money market both as a lender and borrower of funds ranging from overnight money to money for 14 days.

d) **Dealing in Commercial Papers, Certificates of Deposits and Government Securities:** DFHI offers its bid rates in respect of Commercial Papers and Certificates of Deposit. The Bid rate is the discount rate at which DFHI is ready to buy CDs/CPs from the market. DFHI also participates in auctions of Government dated securities.

Discount and Finance House of India Ltd. provides liquidity in the money market by dealing in the money market instruments, including Treasury Bills. It deals in Treasury Bills in the primary market and secondary market as well. The following table shows the figure of its turnover of such bills during the financial year 2000-01:

Table: 7.2 : DFHI's Turnover in Treasury Bills

	Rs. crore
(A) Primary Market Turnover	**2410.98**
(i) Purchase at auctions (including developments)	2186.43
(ii) Maturities	224.55
(B) Secondary Market Turnover	**22082.08**
(i) Outright	3946.52
(ii) Repos	18135.56
Total Turnover (A + B)	**24493.06**

DFHI participates in all auctions of treasury bills and a minimum bidding commitment for each treasury bills auction is prescribed. During 2000-01 the extent of minimum commitment was fixed at 18% as against 15% for the previous year. During 2000-01 DFHI achieved a success rate of 42.11% much above the prescribed minimum. DFHI also earned underwrite fee on Treasury Bills during the year. But with effect from June 2000, Reserve Bank of India has discontinued the practise of payment of this fee.

DFHI's turnover (i.e. purchase and sale) in Treasury Bills in the Secondary Market comprises both on outright basis and on repo basis. The Repos imply sale/purchase of Treasury Bills on the condition that the buyers/sellers will sell or buy the Treasury bills from the Discount House on a pre-determined price in the coming days. Discount House of India provides two-way quotes for this purpose—one for bids and the other for offer. These rates were 6.9% and 6.85% respectively as on 30th November, 2001 indicating a very small difference between the two.

Check Your Progress 2

1) What do you understand by Call Money Market?

....

....

....

2) Why are Treasury Bills issued and by whom?

....

....

....

3) Discuss the role of Discount and Finance House of India developing a Secondary Market for Treasury Bills.

....

....

....

7.5.2 Commercial Bills of Exchange

Commercial Bills of Exchange arise out of genuine trade transactions and are drawn by the seller of the goods on the buyers (i.e. debtors), where goods are sold on credit. They are called 'Demand Bills', when payable on demand or on presentment before the buyer, who is called the 'drawee' of the bill. Alternatively, the bills may be payable after a specified period of time, e.g. 30, 60 or 90 days. Such bills are called 'Usance Bills' and need acceptance by the drawee. By accepting the bills, the drawee gives his consent to make payment of the bills on the due date. Thus, payment of the bills is assured on the dates of maturity. These bills are, therefore, called self-liquidating in nature.

The drawee of the bill (i.e. the seller of the goods) generally discounts the bill with a commercial bank. By discounting is meant that the bill is endorsed in favour of the banker, who makes payment of the amount of the bill less discount (i.e. interest on the amount for the period of the bill) to the drawee. Thus, the drawee gets payment of the bill (less discount) immediately. The discounting banker, however,

recovers the money from the acceptor of the bill on the due date of the bill. The bill is thereafter extinguished.

Commercial Bill of Exchange is a negotiable instrument i.e. it may be negotiated (or endorsed/transferred) any number of times till its maturity. When the discounting bank falls short of liquidity, it may negotiate the bill in favour of any other bank/financial institution or the Reserve Bank of India and may receive payment of the bill less re-discounting charges (i.e. interest for the unexpired period of the bill). This process is called re-discounting of Commercial Bills and may be undertaken several times, till the date of maturity of the bill.

The Reserve Bank of India introduced a Bills Re-discounting Scheme in 1970. Under this scheme bills are re-discounted by Reserve Bank of India or by any scheduled bank/financial institution/investment institution/mutual fund. But important pre-conditions are that the bill should arise out of a genuine trade transaction, must be accepted by the buyer's banker either singly or jointly with him and the period of maturity should not exceed 90 days.

Commercial bill of exchange, thus, is an instrument through which the banks/financial institutions/mutual funds may park their surplus funds for a shorter period as they can afford. Thus liquidity imbalances in the financial system are removed or minimised. Reserve Bank of India has taken several steps in the past, but the practice of drawing bills has not become very popular in India. The obvious reason is the strict discipline that it imposes on the acceptor of the bill to make payment of the bill on the due date. Bills purchased and discounted by Scheduled Commercial Banks in India as on March 31, 2001 constituted just 3.88% of their total assets (i.e. Rs. 50224 crores). But the outstanding amount of commercial bills re-discounted by them with various financial institutions was Rs. 1013 crores as on the same date. This shows that bills re-discounting with other financial institutions is to a limited extent only.

7.6 CERTIFICATES OF DEPOSITS

A Certificate of Deposit is a receipt for a deposit of money with a bank or a financial institution. It differs from a fixed Deposit Receipt in two respects. First, it is issued for a big amount and second, it is freely negotiable. The Reserve Bank of India announced the scheme of Certificates of Deposit in March 1989. The main features of the scheme are as follows:

i) Certificate of Deposits can be issued by Scheduled Commercial Banks (excluding Regional Rural Banks) and the specified All-India Financial Institutions like Industrial

Development Bank of India (IDBI), Industrial Finance Corporation of India (IFCI), Industrial Credit and Investment Corporation of India (ICICI), Small Industries Development Bank of India (SIDBI), Industrial Investment Bank of India (IDBI), and the Export Import Bank of India (Exim Bank).

ii) Certificates of Deposits can be issued to Individuals, Associations, Companies and Trust Funds.

iii) Certificates of Deposits are freely transferable by endorsement and delivery after an initial lock-in period of 15 days after which they may be sold to any of the above participants or to the Discount and Finance House of India (DFHI).

iv) The maturity period of Certificate of Deposits issued by Banks may range from 3 months to 12 months while those issued by specified Financial Institutions may range from 1 to 3 years.

v) Certificate of Deposits are to be issued at a discount to the face value.

vi) Presently there is no limit on the amount which a Bank may raise through Certificate of Deposits. Initially, though, there was a limit linked to the fortnightly aggregate average deposits of the bank.

vii) The minimum amount for which they may be issued is now pegged at Rs. 5 Lacs. (Reduced from Rs. 25 Lacs).

viii) The minimum size of issue of Certificate of Deposits to a single investor is Rs. 5 Lacs, thereafter they can be issued in multiples of Rs. 1 Lac. (with effect from October 1997).

ix) Banks and Financial Institutions are required to issue CDs only in dematerialised form with effect from June 30, 2002. The existing CDs are to be converted into demat forms by October 2002.

Certificate of Deposits are a popular avenue for companies to invest their short-term surpluses because Certificate of Deposits offer a risk-free investment opportunity at rates of interest higher than Treasury bills and term deposits, besides being fairly liquid. For the Issuing Banks, Certificate of Deposits provide another source of mobilizing funds in bulk.

The outstanding amount of Certificate of Deposits of scheduled commercial banks declined perceptibly to a level of Rs. 12,134 crores for the fortnight ended March 28, 1997 from Rs. 16,316 crores for the fortnight ended March 29, 1996. Due to lack of demand for funds and the general decline in the interest rates, the discount rates range on

Certificate of Deposits declined substantially from 12.00—22.25% for the fortnight ended March 29, 1996 to 7.00—15.75% for the fortnight ended March 28, 1997 and further to 7.30—12.50% for the fortnight ended September 12, 1997.

In subsequent years, the total amount of outstanding CDs has been continuously on the decline. The amount of such CDs declined from Rs. 14,584 crores during the fortnight ending May 5, 2000. Thereafter there has been a slight revival in the amount of outstanding CDs, when the figure touches Rs. 1,695 crores on October 20, 2000. The effective rate of interest on CDs has also witnessed sharp decline from 8.25 to 24% to 6.30% to 14.06% range during this period.

7.7 COMMERCIAL PAPER

Commercial Paper is a short-term usance promissory note with fixed maturity, issued by creditworthy and highly rated corporations. It is negotiable by endorsement and delivery. The Reserve Bank of India permitted its introduction in January 1990 as an additional source of short-term finance to corporates and also as an avenue for investment of funds by large investors.

Reserve Bank of India has issued guidelines for issuance of commercial paper. These guidelines, as amended in October, 2000 have the following features:

i) **Eligibility:** Commercial Paper may be issued by Primary Dealers, Secondary Dealers and All India Financial Institutions, besides the corporates.

The eligibility conditions prescribed for the corporates are:

a) Tangible net worth should be Rs. 4 crores,

b) It should have a sanctioned working Capital limit from a bank or financial institution, and

c) The borrowed account should be a standard asset.

ii) **The Instrument of Commercial Paper should have:**

a) A minimum maturity period of 15 days and the maximum period upto one year.

b) A minimum amount of Rs. 5 lakhs and thereafter in its multiplies.

c) Minimum credit rating of P_2 of CRISIL or equivalent rating by other approved credit rating agencies.

iii) **The Investors in Commercial Paper:** CPs can be held by individual banks, corporates, unincorporated bodies, Non-Resident Indians and foreign financial institutions.

iv) **Methods of Issuing Commercial Paper:** Only Scheduled Banks can act as issuing and paying agents. CPs can be issued as a promissory note or in a dematerialised form. With effect from June 30, 2001, it is mandatory that all fresh issuance and investments in CPs should be in dematerialised form. Existing CPs were also required to be converted into demat form by October 31, 2001. Underwrit is not permitted.

CPs are issued at a discount to face value. Discount rate is freely determined by the issuing company. CPs are freely transferable. The issuing company bears all expenses, e.g. dealers' fees, rating agency's fees and other charges.

CPs are required to be issued as a 'stand alone' product. It means that while the banks and financial institutions fix working capital limits for the Corporates issuing CPs, they will take into account all sources of finance available to the Company, including the CPs.

Commercial Paper in India

Issuance of Commercial Paper by the eligible corporates has now become an established practise because of its lower cost. Total outstanding amounts of CPs ranged between Rs. 5000 crores and Rs. 8000 crores during January 1999 and July 2001. The typical effective rates of discount ranged between 8% to 12% during this period and varied from time to time.

Scheduled Commercial Banks have been the predominant investors in CPs and their outstanding holding was Rs. 6,984 crores as on 23rd March, 2001 (as against the total outstanding amount of Rs. 6,991 crores as on 15.3.2001)

Check Your Progress 3

1) State the pre-condition for re-discounting a Commercial Bill by RBI under Re discounting Scheme, 1970.

....

....

....

....

2) What are Certificates of Deposits? How do they differ from fixed deposits in banks?

....

....

....

....

3) What do you understand by Commercial Paper? Give the salient features of the guidelines issued by Reserve Bank of India in this regard.

....

....

....

7.8 LET US SUM UP

The financial markets play a significant role in the economy of a country. These markets are of two types: Money Market and Capital Market. Money Market deals in short-term funds upto the period of one-year. Commercial and Co-operative Banks, Discount and Finance House of India Ltd., financial and investment institutions, Reserve Bank of India, corporates and Mutual Funds participate in the money market. As a Central Bank, Reserve Bank of India performs various tasks including the effective regulation of financial institutions. It provides refinance facilities to the banks through the schemes like Interim Liquidity Adjustment Facility (ILAF) and Liquidity Adjustment Facility (LAF). Call Money Market and Short Notice Money Market are important constituents of the money market.

Earlier several non-bank entities such as financial institutions and selected corporates were permitted to lend directly in the call/notice money market. However, with a view to reduce the volatility in the market, RBI has taken steps to reduce the participation of non-bank institutions in the Call Money Market. Treasury Bills, Commercial Bills of Exchange, Certificates of Deposit, Commercial Paper are the important instruments for short-term borrowings in the money market.

7.9 KEY WORDS

Additional Collateralised Facility : This facility is in addition to the collateralised lending facility. It is granted at Bank rate plus 2% points.

Call Money Market : This is the market for short-term funds, generally for one-day or a few days. Banks lend their short-term surplus funds in this market to other banks. Other institutions also participate as lenders only.

Certificates of Deposits : It is a receipt for deposits made with a bank or financial institution. It is freely transferable instrument.

Collateralised Lending Facility : Under this facility, Reserve Bank of India provided funds to the Commercial Banks upto 0.25% of their fortnightly average outstanding deposits in 1997-98. Such facility was granted for two weeks at Bank rate.

Commercial Paper : It is an unseamed short-term debt instrument issued by credit worthy corporates and financial institutions. Its maturity ranges between 15 days and one year. It is negotiable instrument.

Liquidity Adjustment Facility (LAF) : At present Reserve Bank of India manages liquidity in the economy through the repo and reverse repo auctions under the Liquidity Adjustment Facility. It absorbs liquidity from the system through repos and release funds through reverse repos.

Money Market Instruments : Instruments through which funds are transacted for short-term period in the money market are called money market instruments for example, certificates of deposits, commercial papers, bills of exchange.

Refinance Facilities : The Reserve Bank of India, IDBI, SIDBI, NABARD and Exim Bank provides loans to banks against the loans granted by them. Such loans constitute refinancing.

Repo Auctions : Repo is the right to repurchase the security. Under repo auctions the borrower retains the right to take back the security by repaying the borrowed amount. Under repo auctions Reserve Bank of India sells the securities and thus, contracts liquidity, wherever there is excess liquidity.

Treasury Bills : These are instruments for short-term borrowings by Government of India and are issued on its behalf by Reserve Bank of India. At present they are issued by auction for 91 days and 365 days.

Variable Reverse Repo Auctions : Under the reverse repo auctions Reserve Bank of India releases funds in the system by buying securities in the auction.

7.10 SOME USEFUL BOOKS

L.M. Bhole (3rd Edition, 2002): Financial Institutions and Markets, *Tata McGraw Hill,* Delhi.

P.N. Varshney & D.K. Mittal (4th Edition, 2002): Financial System in India, Sultan Chand & Sons, Delhi.

Govt. of India—Economic Survey, 2000, 2001, 2002

Reserve Bank of India—Annual Reports, 2000, 2001

Report of the Working Group on Money Market (Chairman: N. Vaghul), 1987

Report of the Committee on Banking Sector Reforms (Chairman: M. Narsimham), 1998

7.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Money Market is the market which deals in short-term funds ranging from overnight to a year.

   The major participants in the money market are: Commercial and Co-operative Banks, Discount and Finance House of India Ltd (DFHI), RBI, Financial and investment institutes like LIC, UTI, GIC etc.

2) See Section 7.32

3) i) Money Market is the market for short-term funds upto one-year duration whereas capital market deals in long-term funds.

   ii) Repo is a method of borrowing against certain securities for a short period whereas reverse repo is a method of lending against the securities with the commitment to take back the securities from the borrower against payment at a specified price.

Check Your Progress 2

1) Market for money at call and short notice is knows as Call Money Market.

2) The Treasury Bills are issued to bridge the mismatch

between the timings of Government receipts and expenditure. Treasury Bills are issued by RBI.

3) See Sub-section 7.5.1

Check Your Progress 3

1) i) The bill should arise out of a genuine trade transaction.

   ii) It must be accepted by the buyer's banker either singly or jointly with him.

   iii) Period of maturity should not exceed 90 days.

2) Certificate of Deposit can be defined as a receipt for a deposit of money with a bank or a financial institution. They differ from fixed deposits in two senses:

   a) certificate of deposit is issued for a big amount,

   b) it is freely negotiable.

3) See Section 7.7

UNIT 8 CAPITAL MARKET I : NEW ISSUES MARKET

Structur

8.0 Objectives
8.1 Introduction
8.2 Primary Market and Secondary Market
8.3 Methods of Floatation of New Issues
  8.3.1 Public Issue
  8.3.2 Rights Issue
  8.3.3 Private Placement
8.4 Entry Norms for New Issues
8.5 Fixation of Premium
  8.5.1 Book Building Process
8.6 Reforms in Primary Capital Market
8.7 Recent Trends in New Issues Market in India
8.8 Let Us Sum Up
8.9 Key Words
8.10 Some Useful Books
8.11 Answers/Hints to Check Your Progress

8.0 OBJECTIVES

After going through this unit you will be able to :

- explain the concept of capital market and its segments,
- describe the various means to raise the capital in the primary market,
- describe the reforms in primary capital market, and
- state the recent trends in new issues market in India.

8.1 INTRODUCTION

We know that Financial markets are broadly categorized into Money market and Capital market. In the previous Unit, we have studied the functioning of money market and its various instruments. In this Unit, we will deal with the capital market.

The process of industrial growth requires the development of the capital market, which provides long-term finance to entrepreneurs. The capital market is a wide term and includes all transactions involving long-term funds. The development banks, commercial banks, financial institutions and stock exchanges, are its important components. The Securities and Exchange Board of India (SEBI) is the regulator over the Capital Market. Capital market is an organized market for effective and efficient mobilization of funds from the

numerous savers and transfers the funds to those who are in need of money to finance business operations either in the private sector or in the public sector. In other words, capital market brings together the parties who demand the funds (Industry and Business) and who supply the funds (Investors). Capital Market, therefore, is a link between savings surplus sector (Household) and saving deficit sector (Industry).

In the Capital Market, we largely deals with the securities such as equity shares, preference shares, bonds and debentures issued by corporates, semi-Government organizations and Governments.

8.2 PRIMARY MARKET AND SECONDARY MARKET

The Securities Market is divided into two segments—the Primary Market and the Secondary Market. The main difference between these two lies in the fact that while the former deals with the securities, which the issuer issues for the first time, the latter deals in the existing securities. Thus, the primary market facilitates the transfer of investible funds of the savers to the corporates, which need them for productive purposes. In the Secondary Market, no new securities come into existence, rather the existing securities change hands—one set of persons invest in them, while the other group disinvests. The Primary Market, also called the New Issues Market, is of vital importance in the economy of a country, as it leads to better utilisation of otherwise inactive or dormant monetary resources in the economy.

These two markets are not isolated from each other, rather they are very much inter-dependent. Activities in the new issues market and the response of the investors to the new issues of securities depend upon the prevailing conditions in the Secondary Market. If the secondary market is vibrant and booming, issues of new securities in the Primary Market will be easily able to mobilise support of a large number of investors and vice-versa. We shall study in this Unit the existing practices for floating new issues in the Securities Market.

8.3 METHODS OF FLOATATION OF NEW ISSUES

There are three ways in which a company may raise capital in the primary market.

i) Public Issue

ii) Rights Issue

iii)Private Placement

8.3.1 Public Issue

The most important mode of issuing securities is by issuing prospectus to the public. If the issue has been made for the first time, by a corporate body, it is known as Initial Public Offer (IPO).

The procedure followed in cases of public issue is as follows:

Invitation to subscribe the share is made through a document called 'prospectus'. The applications on the prescribed form, along with application money, are invited by the company. The subscription list is open for a period of 3 to 7 days.

No allotment can be made unless, the amount stated in the prospectus as the minimum subscription has been subscribed, and the company has received sum payable on application. Minimum subscription refers to the number of shares, which should be subscribed. As per the SEBI guidelines, minimum subscription has been fixed at 90% of entire public issue.

Generally, the amount is mobilized in two instalments-application money and allotment money. If the full amount is not asked for at the time of allotment itself, the balance is called up in one or two calls thereafter known as call money. The letter of allotment sent by the company is exchangeable for share certificates. If the allottee fails to pay the calls, his shares are liable to be forfeited. In that case, allottee is not eligible for any refund.

The public issue may also be underwritten by an underwriter. Underwriting is not mandatory now. An underwriter gives an undertaking, to the issuing company to take the unsubscribed shares. This is called devolvement of shares on the underwriters, for which they are paid a commission.

In India underwriting agencies can be classified into following categories: 'sole underwriting', 'syndicate underwriting', a 'sub-underwriting under sole underwriting'. An underwriter enters into an agreement for underwriting with the issuing company all alone. Syndicate underwriting is used when the investment bankers form a syndicate to purchase the securities of company because money needed for such venture may be larger than any one banker may like to invest. The third underwriting method i.e. sub-underwriting, involves appointment of a sub underwriter to quicken the sale of securities and diversify the risk involved. Two types of agreements are involved in underwriting, e.g.

- Agreement between issuing company and the underwriters
- Agreement between the underwriter(s) and sub-underwriter(s)

8.3.2 Rights Issue

A rights issue involves selling securities in the primary market by issuing rights to the existing shareholders. In this method the company gives the privilege to its existing shareholders for the subscription of the new shares on pro rate basis. A company making a rights issue sends a letter of offer along with a composite application form consisting of four parts A, B, C, and D. Part A is meant for acceptance of the offer. Part B is used if the shareholder wants to renounce his rights in favour of someone else. Part C is filled by the person in whose favour the renunciation has been made. Part D is used to request the split of the shares. The composite application form must be mailed to the company within a stipulated period, which is usually 30 days. The shares that remain unsubscribed will be offered to the public for subscription. Sometimes an existing company can come out with a simultaneous 'Right cum Public Issue'.

The important characteristics of rights issue are:

1) The number of shares offered on rights basis to each existing shareholder is determined by the issuing company. The entitlement of the existing shareholder is determined on the basis of existing shareholding. For example one Rights share may be offered for every 2 or 3 shares held by the shareholder.

2) The issue price per Rights share is left to the discretion of the company.

3) Rights are negotiable. The holder of rights can transfer these rights shares to any other person, i.e. he can renounce his right to subscribe to these shares in favour of any other person, who can apply to the company for the allotment of these shares in his name.

4) Rights can be exercised during a fixed period, which is usually 30 days. If it is not exercised within this period, it automatically lapses.

8.3.3 Private Placement

A Public Issue is a costly affair involving Press advertisements, brokers, fees and Press conference, etc. Therefore, some of the companies find it easy and cheaper to raise funds through private placement of bonds and shares.

In this method, the securities are issued to some selected investors like banks or financial institutions. The private placement agreement is undertaken when the issue size is not very big and the issuer does not want to spend much on floating the issue. Private placement market has grown phenomenally. During the last few years in India, the rate of growth of private placements has been higher than public issues as well as right issues because of following advantages:

i) **Accessibility:** Whether it is a public limited company, or a private limited company, or whether it is listed company or an unlisted one, it can easily access the private placement market. It can accommodate issues of smaller size, whereas public issue does not permit issue below a certain minimum size.

ii) **Flexibility:** There is a greater flexibility in working out the terms of issue. A private placement results in the sale of securities by a company to one or few investors. In case of private placement, there is no need for a formal prospectus as well as under-writing arrangements. Generally, the terms of the issue are negotiated between the company (issuing securities) and the investors.

When a non-convertible debenture issue is privately placed, a discount may be given to institutional investor to make the issue attractive.

iii) **Speed:** The time required, for completing a public issue is generally 6 months or more because of several formalities that have to be gone through. On the other hand, a private placement requires lesser time.

iv) **Lower Issue Cost:** A public issue entails several statutory and non-statutory expenses associated with underwriting, brokerages etc. The sum of these costs used to work out even upto 10 percent of issue. For a company going for a private placement it is substantially less.

Check Your Progress 1

1) What are the different ways in which a company can raise its capital?

....

....

....

2) What is private placement? What are its advantages?

....

....

....

3) Which document does provide the details of the proposed public issue?

....

....

....

4) What is underwriting of an issue?

....

....

....

8.4 ENTRY NORMS FOR NEW ISSUES

The experience of free pricing of new issues, introduced in 1992, did not prove useful, as there was great influx of companies in the new issues market, at high premium. The Securities and Exchange Board of India imposed strict norms for the entry of companies in the new issues market in April 1996. It requires that only those companies will be allowed entry into the share market, which have track record of dividend payments in the last 3 years. This requirement was changed in 1999 to ability to pay dividend in each of the 3 years. Alternatively, in case of manufacturing companies, its project must have been appraised by a scheduled bank/ financial institution, which is also providing loan/equity to the extent of 10% of the project cost. Thus, only profit earning and dividend-paying existing companies and new companies, with their projects appraised by banks/ financial institutions, are permitted to enter into the new issues market. This step has been taken to improve the quality of shares being issued in the primary market. You will study the full details of the SEBI guidelines in Unit-10.

8.5 FIXATION OF PREMIUM

Companies are allowed to issue their securities at par, at a premium or at a discount. When the issue price is equal to the face value of the security, it is issued at par, if the former exceeds the latter, it is issued at a premium, and in the reverse condition at a discount. The amount charged from the investors above the face value is called **'Premium'**. For example, if the share of the face value of Rs. 10, is issued for Rs. 15, the extra amount of Rs. 5/- is called Premium.

Till May 1992, companies were required to seek the permission of the Controller of Capital Issues, under the

Control on Capital Issues Act, to issue capital above the permitted amount. The amount of premium was also determined by the Controller of Capital Issues, taking into account various facts relating to the Company's functioning.

In May 1992, the above Act was repealed and instead the Securities and Exchange Board of India (SEBI) was empowered to exercise control over the new issues market as well. The SEBI subsequently permitted the companies to determine the premium themselves. However, SEBI issued guidelines in this regard, which divided the companies into three categories, and within each category, companies which fulfilled conditions of consistent profit for specific number of years are permitted to charge premium. Rest of them is permitted to issue the shares at par only. This led to great rush in the new issues market and companies charged heavy premium for their issues. You will study the details of these guidelines in Unit-10 dealing with Regulatory framework for Capital Market.

8.5.1 Book Building Process

A new system to determine the amount of premium to be charged by a company on its new issues was introduced in October 1995, when SEBI permitted the system known as **'Book Building'**. It is a pricing mechanism wherein new issues are priced on the basis of demand feedback. Under this system, the price of the new issue is based on real time feedback from the investors.

The mechanism adopted under the Book Building is as follows:

- A draft prospectus containing all information, except the price and the number of securities, is filed by the Company with SEBI.
- A lead merchant banker to the issue is appointed as Book Runner.
- The Book Runner will circulate copies of the prospectus amongst the institutional investors and underwriters inviting offers for subscription to the security.
- The Book Runner maintains a record of the offers received from the institutional investors and underwriters mentioning the price they are ready to pay and the number of securities they intend to buy.
- On the basis of these offers, the Company and the book runner will determine the price of the security. The price, so determined, will be the same for both placement position and the public issue.

- Thereafter, the Underwriting Agreement is entered into and prospectus is filed with the Registrar of Companies.
- One-day prior to the public issue, institutional investors are required to submit application forms along with money to the extent the securities are proposed to be allotted to them.

Initially, the book-building process was optional to the companies, but gradually, an element of compulsion has been introduced.

During the fiscal year 2000-01, the book-building route was made compulsory for companies, which do not have the track record of profitability and networth as specified in Entry norms prescribed by SEBI.

Moreover, 60% of the offer made by them is to be allotted to 'Qualified Institutional Buyers', comprising financial institutions, banks, mutual funds, Foreign Institutional Investors (FIIs) and Venture Capital Funds registered with SEBI. Inability to meet this condition is regarded as failure of the issue.

The book-building route has also been made compulsory for IPOs with issue size more than 5 times the pre-issue networth and for public issues by listed companies worth more than 5 times the pre-issue net worth. In these cases also, 60% of the offer should be allotted to QIBs.

Check Your Progress 2

1) What do you mean by the premium? Who can charge premium?

....

....

....

2) What do you understand by entry norms for new issues? Discuss briefly.

....

....

....

3) What is book-building process?

....

....

....

8.6 REFORMS IN PRIMARY CAPITAL MARKET

SEBI has brought about several reforms in the new issues market during recent years. Important reforms are as detailed below:

i) **Minimum offer to public:** SEBI (Disclosure and Investor Protection) Guidelines required a minimum offering of 25% of post-issue capital to the public. This requirement was gradually relaxed to 10% for companies in all sectors. For this purpose, SEBI also kept the minimum offering size at Rs.100 crore and retained the existing limit of minimum public offering of 20 lakh shares. The Companies which are unable to meet these conditions are required to make a minimum public offering of 25%.

ii) **Lock-in-period**: The provisions for lock-in applicable to IPOs have been rationalized. Lock-in-period for minimum promoters' contribution of 20 per cent continues to be 3 years, the balance of the entire pre IPO Capital held by promoters and others shall have lock-in period of 1 year from the date of allotment of the IPO.

The shares issued on preferential basis by a listed company to any person shall have a lock-in period of one year term from the date of their allotment.

iii) **Allotment of Shares:** The time for finalizing the allotment of share has been reduced from 30 days to 15 days, in case, issues are made on book-building basis.

iv) Merchant bankers have been brought under SEBI regulatory framework and a code of conduct is issued for them.

v) Companies are required to disclose all material facts and specific risks factors associated with their projects while making public issues through the prospectus.

vi) Prohibition has been imposed on payment of any direct or indirect discounts or commission to person receiving any firm allotment of shares.

vii) The requirement of 90% minimum subscription in case of offer for sale is no longer applicable.

viii) Underwriting of the issue made optional subject to the condition that if an issue was not underwritten and was not able to collect at least 90% of amount offered to public as subscription, the entire amount will be refundable to investors.

ix) SEBI introduced a code of advertisement for public issues for ensuring fair and truthful disclosures

8.7 RECENT TRENDS IN NEW ISSUES MARKET IN INDIA

The new issues market in India has passed through both the phases of boom and depression during the last decade. The number of new public issues shoot up from 528 in 1992-93 (Amount Rs. 6060.83 crores) to 770 in 1993-94 (Rs. 12544 crores) and thereafter to 1343 and 1428 during 1994-95 and 1995-96 amounting to Rs. 13311.00 and Rs. 10981.72 crores respectively. This was largely due to optimistic outlook following free pricing of shares allowed by SEBI.

Table-8.1 shows the mobilization of resources from the primary market during the last few years. The following trend emerges from the table:

i) Though, the numbers of issues and their amounts have increased during recent past from 367 (Rs. 59044 crores) in 1997-98 to 737 (Rs. 73921 crores) in 2000-01, the major portion was raised through private placement route. Within this category, public sector dominated and accounted for a bigger portion. IDBI, IFCI, ICICI, IIBI were the largest mobilizers of funds in this category, followed by state level undertakings. Thus, we may conclude that private placement of shares/debentures, bonds, etc. have become popular because of adverse sentiments towards equities and lower cost of placement route. The willingness of banks and other financial institutions to subscribe to debt instruments through private placement has also been a contributing factor.

ii) The number of new issues through prospectus and rights, which fell to 51 in 1998-99, rose to 83 in 1999-2000 and further to 150 in 2000-01. But their amounts continuously declined from Rs. 9365 crores to Rs. 6421 crores. These figures include both of the public issues through prospectus and the rights issues.

iii) Public Sector undertakings and Government companies remained absent from the public issues market during the last three years. Resource mobilization by banks and financial institutions in the public sector declined sharply.

iv) Out of 145 issues made by Non-Government public limited companies, 134 issues were of equity shares, the remaining being debt issues. But in terms of resource mobilization, the shares of equity instruments was only 53.9%. Most of the issues during 2000-01 were of Rs. 10 crores and less, while in the previous year most of the issues were of Rs.10 crore and above. As a result, the average size of issues by private sector companies sharply declined to Rs. 34 crores from Rs. 65 crores in 1999-2000 and Rs. 104 crore in 1998-99.

v) The above figures of total amount mobilized by equity issues include the amount of premium also. The share of premium in the total amount mobilized by equity shares declined sharply to 47.5% in 2000-01 from 78.8% in the 1999-2000, while it was 51.7% in 1998-99. This rise in premium was due to successful initial public offering of companies in Information Technology Sector.

In brief, it can be stated that the public issues market in India at present is not very attractive to the retail investors because of the economic slow down and the depressed share prices in the Secondary Market. Corporates have, therefore, preferred the route of private placement of debt instruments. Resource mobilization through IPOs accounted for only 5.5% of the total resource mobilization during April-December 2001, compared with 56.7% in the corresponding period of last year. Banks and financial institutions raised about 70% of this amount. Amount raised by IT Companies was less than 1%. In March 2002, Punjab National Bank, however, made its successful IPO, which was over-subscribed by over 4.5 times and that too at a premium of Rs. 21 per share of Rs. 10 each. It shows revival of the small investors interest in the IPOs, especially those of banks and financial institutions.

Table 8.1
Mobilisation of Resources from the Primary Market in India

(Amount in crore rupees)

Security & Type of Issue	1997-98		1998-99		1999-2000		2000-2001	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount
A: Prospectus & Rights			**51**	**9,365.1**	**83**	**7,704.3**	**150**	**6,421.1**
(1) Non-Govt Public Ltd. Companies	102	3,138.3	48	5,013.1	79	5,153.3	145	4,948.9
(a) Equity Shares	89	1,162.4	33	2,562.7	69	2,752.5	134	2,666.5
(b) Preference Shares	1	4.3	3	59.7	—	—	2	142.2
(c) Debentures	12	1,971.6	12	2,390.7	10	2,400.8	9	2,140.2
(2) Banks and Financial Institutions			3	4,352.0	4	2,551.0	5	1,472.2
B: Private Placement			**316**	**49,679.0**	**578**	**61,259**	**587**	**67,500**
(1) Private Sector			180	16,997.7	367	19,403.5	387	24,398.8
(2) Public Sector			136	32,681.3	211	41,855.5	200	43,101.2
Total (A+B)			**367**	**59,044**	**661**	**68,963.3**	**737**	**73,921.3**

Source: Annual Report of Reserve Bank of India (2000-2001)

Check Your Progress 3

Match the following:

	A	B
i)	Lock in Period for minimum promoters' distribution of 20% continues to be	(a) 90
ii)	SEBI's guidelines require a minimum offering of post issue of capital to the public to the percentage	(b) 3
iii)	The minimum percentage subscription in case of offer for sale is no longer	(c) 25

8.8 LET US SUM UP

Financial Market is broadly categorised into Money Market and Capital Market. Capital Market deals with the long-term funds such as equity shares, preference shares, bonds and debentures issued by the corporate sector, semi-government organizations and other financial institutions.

The security market is divided into two segments-Primary Market and Secondary Market. The former deals with the securities, which the issuer issues for the first time, while the latter deals in the existing securities. Any company can raise the capital in the primary market by three ways, namely—Public Issue, Rights Issue and Private Placement. Companies are allowed to issue their securities either at par, or at a premium, or at a discount.

The Securities and Exchange Board of India (SEBI) has imposed strict norms for entry of companies in the new issues market with effect from April, 1996. A new system namely **'Book Building'** has been adopted by SEBI to determine the amount of premium to be charged by a company. SEBI has brought several reforms in the new issues market during recent years. These include minimum offer to public, lock-in-period for minimum promoters' contribution of 20% and reduction of time from 30 days to 15 days for finalising the allotment of shares.

Recent trends in new issues market in India indicate revival of the small investors' interest in the primary issues specially those of banks and financial institutions.

8.9 KEY WORDS

Bonds : Bond refers to a security issued by a company, financial institution, or Government, which offers regular or fixed payment of interest in return.

Boom	:	A condition of the market denoting increased activity with rising prices and higher volume of the business resulting from greater demand to securities.
Buyback	:	The arrangement agreed to between the company and its investors to buy back the securities at a later date for a specific price.
Coupon Rate	:	It is the rate of interest, which the issuer pays in the principal/paid up value of the bond. It is fixed at the time of issuance of the bond.
Deep Discount Bonds	:	This bond is issued at a discount on the face value. The face value is paid at the maturity. These bonds are also known as Zero Coupon Bonds.
Gilts	:	Fixed interest securities by the government to raise money for public expenditure in India by auction across.
Securities & Exchange Board of India (SEBI)	:	Set up in April 1988 by the Government of India with the objective of promoting healthy and orderly development of the securities market and ensuring investors protection.
Split	:	Sub division of share of large denomination into share of smaller denomination. Also means sub division of holding.
Stag	:	An application for a new issue of shares that hopes to sell the shares on allotment at a profit once trading commences in the secondary market. A speculator is one who buys and sells stocks rapidly for fast profits.
Underwriting	:	An individual or institution guaranteeing subscription in part or in full of a security issue at a later date for a specified price.
Volatility	:	A measure of the price moment of a security during a specific period.

8.10 SOME USEFUL BOOKS

Verma, J.C. (1997): *'Venture Capital Financing in India'*, Response Books, Sage Publication India (Pvt. Ltd).

Marilu Hurt Mc. Carty (1988): *Money & Banking Financial Institutions and Economic Policy* (2nd Edition), Longman Financial Services Publishing, USA, Chapter 4, PP. 80-86.

Economic Survey: 1999-2000, Chapter 4, P.P. 59-73

Report on Currency and Finance, 1991-92: Chapter 9, Capital Market, PP. 294-307, Reserve Bank of India, Mumbai

8.11 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Company can raise capital through public issue, rights issue and private placement.

2) If securities are issued to some selected investors, it is referred to as private placement. Easy accessibility, flexibility and the lower cost are its main advantages.

3) Prospectus

4) Underwriting of issue refers to the promise committed by a third party that the underwriter will take up the subscribed shares.

Check Your Progress 2

1) Premium refers to the difference between issue price and the face value of the security. Companies under the norms of SEBI can charge premium.

2) See Section 8.4

3) See Sub-section 8.5.1

Check Your Progress 3

i) (b) ii) (c) iii) (a)

UNIT 9 CAPITAL MARKET II : SECONDARY MARKET

Structure

9.0 Objectives
9.1 Introduction
9.2 Stock Exchange in India
9.3 Trading System at Stock Exchange
  9.3.1 Traditional Trading System
  9.3.2 On-Line Trading System
9.4 Settlement Procedure for Traded Securities
9.5 Transfer System
9.6 Dematerialisation of Securities
9.7 National Stock Exchange
9.8 Over the Counter Exchange of India (OTCEI)
9.9 Trading in Derivatives
9.10 Let Us Sum Up
9.11 Key Words
9.12 Some Useful Books
9.13 Answers/Hints to Check Your Progress

9.0 OBJECTIVES

After reading this Unit, you will be able to :

- explain the system of Stock Exchanges in India,
- categorise trading, settlement and transfer system on Stock Exchanges,
- analyse dematerialisation of shares,
- describe working of National Stock Exchange and Over the Counter Exchange of India, and
- illustrate trading in derivatives as introduced in India.

9.1 INTRODUCTION

We have learned in Unit 8 that Capital Market largely deals with the securities such as equity shares, preference shares, bonds and debentures. We also know that securities market is divided into two segments, namely the primary market and secondary market.

The secondary market of securities is an important component of the capital market. It is the market where shares, bonds, debentures and other securities are traded. Once these securities are floated, subscribed to and issued to the public, they are traded in the secondary market, which is called **'Stock Market'**.

Stock Market provides liquidity and easy marketability to these securities. Thus, an active secondary market in turn encourages investors to subscribe to the securities in the primary market. The growth and development of the primary market is, therefore, largely dependent upon the vibrant secondary market.

9.2 STOCK EXCHANGES IN INDIA

The market where securities are traded is called the **'Stock Exchange'**. Presently there are 23 Stock Exchanges in the country. Bombay Stock Exchange (BSE) is the oldest and principal Stock Exchange in India. During the last decade, National Stock Exchange (NSE) with its wide network across the country, has become the premier stock exchange in the country. Another new nation-wide exchange is 'Over the Counter Exchange of India (ICEI)'.

The Stock Exchange in India are organised either as voluntary non-profit making organizations or as public limited companies—limited by shares or by guarantees. The Stock Exchange are to be registered with the Central Government and function within the purview of the Securities Contracts (Regulation) Act, 1956 (SCRA). This Act governs the Organization, management, membership and functioning of Stock Exchanges. Moreover, the Stock Exchange is governed by their own rules and bye-laws. The Securities and Exchange Board of India (SEBI) overviews and governs the functioning of Stock Exchanges and their participants. The recognised Stock Exchange is managed by a governing body consisting of elected and nominated members. The Executive Director is the Chief Executive of the exchange.

9.3 TRADING SYSTEM AT STOCK EXCHANGES

Dealing in securities at the Stock Exchange has traditionally been undertaken on the trading floor of the Stock Exchange. This traditional system is now been largely replaced by computerised on-line system of trading. We shall first deal with the traditional system of trading, followed by the new on-line system.

9.3.1 Traditional Trading System

Dealings at a stock exchange are permitted only in the listed securities. The term 'listing of securities' means that the security concerned has been included in the list of securities to be transacted at the Stock Exchange. Only listed securities are allowed to be traded on a stock exchange. Therefore, at the time of making a public issue, companies declare that the security concerned has either been listed

at one or more stock exchange or, an application has been made for that purpose. Listed securities fall in two categories :

i) **Cash List:** It involves ready delivery, and

ii) **Forward List:** It enjoys forward trading privilege.

A security can be listed by the Stock Exchange, if the issuer company fulfils the prescribed conditions.

Transactions at the Stock Exchanges are undertaken through the brokers. Brokers are also now-a-days regulated by Securities and Exchange Board of India. When a person intends to buy or sell shares/bonds of a company, he places an order for the same with a broker registered at the stock exchange. Broker's authorised clerk will carry out the customer's order at the trading floor of the stock exchange by undertaking a transaction with another broker or jobber. Jobber is a person who quotes two-way prices—the bid price and the offer price. After a transaction is finalised, it is noted in the notebooks. Contract notes are prepared and sent to the customer intimating the transaction undertaken for him.

9.3.2 On-line Trading System

A revolutionary change of great significance has taken place with the introduction of on-line trading system, which has replaced the traditional system. The Bombay Stock Exchange introduced this system, which is known as **Bombay Stock Exchange On-Line Trading (BOLT)**.

Under the On-Line Trading System, the trading floor dealings have been discarded. Brokers transact business through their computers, which are linked with the main computer of the Stock Exchange through VSATs (Very Small Aperture Terminals), which have started functioning at various centres. This facility has been extended to other cities also where a stock exchange is already present. A Memorandum of Understanding (MoU) between BSE and other exchanges is signed to allow BSE to install its terminals in their areas.

The *modus operandi* of On-Line Trading is very simple. As soon as a broker receives an order from his customer, he feeds the details of the order into the computer, e.g. the name of company, no. of shares to be purchased/sold, the ceiling price or the price at which the transaction is intended to be made and the time within which is to be completed. The screen of the computer will fully display the present details regarding the security concerned. If the present position does not facilitate the transaction, the computer will store the order and will match it with a corresponding reverse order, as soon as it is feasible. It means that as and when the desired shares are available for sale at the desired

price, the deal is struck and the computer screen will display the completion of the transaction. The broker will, thereafter, issue the contract note.

There are several advantages of the On-Line Trading System. It makes the securities market transparent, as the customer can himself see the market price on the screen. It makes the security market wide and deep. It serves a larger number of investors spread over different locations and covers a large number of securities. The difference in prices of securities at different locations/markets is reduced. It is very convenient, fast and efficient.

Other exchanges have also been permitted to set-up computerised screen based trading system. They can also expand nation-wide subject to certain conditions.

Check Your Progress 1

1) What do you understand by Stock Exchange? Who exercises control over them?

....

....

....

2) Explain the traditional trading system at a Stock Exchange.

....

....

....

3) What do you understand by 'On-Line Trading System? Point out its benefits.

....

....

....

9.4 SETTLEMENT PROCEDURE FOR TRADED SECURITIES

For the purpose of settlement, securities are divided into two groups:

i) **Specified Securities** include actively traded shares of large growth-oriented companies. Only a limited number of shares fall in this group but they account for major portion of capitalisation in Indian Stock Market.

ii) **Non-Specified Securities** are securities other than the specified securities.

There are two methods for settlement of transactions in specified securities:

i) **Carry Forward System:** Under this system, the transactions are settled at the end of each settlement period, which is generally of two weeks commencing on Friday and ending on Thursday of second following week. At the end of the settlement period on Friday, the members decide whether the transaction is settled or if it is to be further carried forward. The carry forward of transactions is called *'badla'*.

In case of non-specified, securities *'badla'* transaction were not allowed. The clearing house handles only the money part and actual delivery of securities is handled by members themselves.

Badla System or Carry Forward System was abolished on December 13, 1993. In October, 1997 SEBI introduced modified carry forward system. Finally SEBI banned 'badla' on July 2, 2001.

ii) **Rolling Settlement System:** In January, 1998 SEBI introduced rolling settlement system on a voluntary basis on the Stock Exchanges for securities, which were eligible for demat trading. In January 2000, compulsory rolling settlement was introduced for 10 scrips. By May 2000, the number of such scrips was gradually increased to 163 and with effect from July 2, 2001 to 251. Rolling settlement was extended to the remaining scrips on all stock exchanges by December 31, 2001.

Thus, rolling settlement system has substituted the Badla System. Now all the scrips are traded in the rolling settlement mode. Initially, rolling settlement was on T + 5 basis, but from April 1, 2002, settlement cycle for all securities has been shortened to T + 3 basis. It means that payment and delivery of securities is to be completed within three days after the day of the transaction. Thus, the rolling settlement system is a significant improvement in the stock market. It will enhance the efficiency and integrity of the securities market.

The payments and deliveries are made by members through the clearing house of the Stock Exchange. They deposit cheques/drafts and securities certificates on the pay-in-day specified by the Stock Exchange. After examining the same, the cleaning house makes the payment and delivers the securities certificates to the members on the pay-out-day, i.e. next Wednesday

The brokers, who trade in securities at the Stock Exchange, have to meet margin requirements also. They have to deposit daily margins in cash for every contract of purchase and sale outstanding at the end of the day for scrips in the

specified group only. Generally, the rate of daily margin varies between 5% and 25%. It is calculated on cumulative aggregate purchase and sales by members, remaining outstanding at the end of each day. They have to deposit other margins also as imposed by the stock exchanges.

9.5 TRANSFER SYSTEM

After the transaction is complete by settlement and delivery of share certificates to the buyer, the latter has to get the share certificates transferred in his own name. For this purpose, the transferor has to sign on the prescribed Transfer Deed, which must be duly stamped, dated and witnessed. Thereafter, it is signed by the transferee and along with share certificate is sent to the registered office of the issuer company (or its registrars who handle the shareholders' register and transfers). The company will tally transferor's signature with his specimen signatures (given at the time of applying for the shares) and other details. If everything is found in order, the shares are transferred in the name of the transferee and an endorsement to this effect is made on the back of the share certificate. Necessary entries are also made in the Register of Members. Share certificates are then sent back to the transferee. Company is allowed two month's time to complete this transfer procedure.

The above is the traditional or conventional method of transfer of shares held in the physical form. With the setting up of Depositories, most of the shares are now not held in the physical form, but in dematerialised form. The system of transfer of shares in demat form is very simple, as explained below.

9.6 DEMATERIALISATION OF SECURITIES

One of the most important reforms in the Indian Capital Market has been the introduction of dematerialisation of securities. Dematerialisation means that the securities do not exist in the physical form, i.e. in the form of share/bond certificates, but holding of such securities are only recorded in the books of an institution called Depository. Whenever, a shareholder transfers his shares to another person, he informs the Depository which makes necessary entries in its books to record such transaction. Thus, the transfer process is facilitated and made foolproof without various disadvantages of physical transfer of shares.

The enactment of Depository Act, 1996 in July 1996 and notification of SEBI (Depository and Participants) Regulations, 1996, have provided a legal framework to record ownership details in a book entry form. The Depository Act, 1996 allows for dematerialisation and (rematerialisation) of

securities in depositories and transfer of securities through electronic book entry. This will help in reducing settlement risks and removing some of the infrastructural bottlenecks. The dematerialised securities are to be fungible, meaning that they will not have any distinctive number or specific identification.

The Depository Act vests SEBI with the power of registration of depositories and participants and to approve or amend the bye-laws of a depository. After the notification of the SEBI (Depository and Participants) Regulations, 1996, the National Securities Depository Limited (NSDL) has been set up. The NSDL, sponsored by IDBI, UTI and NSE commenced operation in October, 1996. NSDL employs state-of-the-art technology and professional management and has introduced international standards and practices of securities handling to the Indian capital market. The setting up of the first depository in the country is a milestone, which is expected to upgrade the trading and settlement system in line with that prevailing in the developed markets. With dematerialisation, all the problems of loss in transit and bad delivery disappear as also the seemingly arbitrary power of companies to refuse transfer on the flimsy grounds are going to be a thing of past.

About 80% of the scrips listed on the stock markets have been dematerialised by October, 2001. For dematerialisation, investors have to open an account with any of the participants and return the share certificates to the company which destroys them and book entries are made in electronic form by the depository.

9.7 NATIONAL STOCK EXCHANGE

National Stock Exchange (NSE) was incorporated in 1992 to provide nation-wide stock trading facilities. Its promoters are the leading financial institutions, e.g. IDBI, IFCI, ICICI, LIC, GIC, SEBI Capital Markets Ltd., Stock Holding Corporation of India and Infrastructure Leasing and Financial Services Ltd. It provides a fully automated screen-based trading system.

NSE has two segments:

i) **Wholesale Debt Market Segment:** In this segment, institutions including subsidiaries of banks engaged in financial services and corporate bodies can enter into high value transactions in debt instruments such as Public Sector Undertaking bonds, treasury bills, Government Securities, Units of UTI, Commercial Papers, Certificates of Deposits, floating rate bonds, etc. The members can trade on their own behalf as well as on behalf of their clients.

ii) **Capital Market Segment:** This segment deals with equities and retail trade in convertible or non-convertible debentures and hybrids. The securities of medium and large companies with nation-wide investor base are dealt with Securities which are traded on other Stock Exchanges can also be traded at NSE.

National Stock Exchange has fully automated screen-based trading system. It is connected through a Very Small earth-based Aperture Terminal (VSAT) or through leased telephone lines. Every member of the NSE trades with other members through a computer located at his office, anywhere in India. Satellite lines are established between the computers of members using VSAT. Through this computer network, all members receive complete market information about a particular share and the company.

For undertaking a transaction, a trading member will enter the order and can specify the conditions for sale/purchase. For example, he may specify the limit on the price, or may state that order be matched at the best price available or at a price better than specified by him. He will also specify the period for which his order will be valid. The NSE computer system will match the order, i.e. the order for purchase of a specific security at a certain price will be matched with another order to sell the same security at the same price, etc. The system does not disclose the identity of one-trading member to the other one.

Check Your Progress 2

1) What do you understand by Rolling Settlement System? Explain its advantages.

....

....

....

2) What is dematerialisation of securities? What are its advantages?

....

....

....

3) What are the special features of National Stock Exchange? Explain its trading system.

....

....

....

9.8 OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)

OTCEI is also a totally computerised, ringless, screen based, automated stock exchange. It was established as a company under section 25 of the Companies Act in 1990 by eight financial institutions. The main objective of its establishment was to help enterprising promoters to set up their projects by raising capital from the market easily and cheaply.

A company, whose security is to be transacted at OTCEI, must be sponsored by a sponsor. A financial institution, mutual fund, scheduled bank, its subsidiary and merchant banker approved by SEBI may be the sponsor. They are high net worth entities. Small and medium sized companies which are unable to meet the listing requirements of other Stock Exchanges (e.g. minimum capital requirement of Rs. 3 crore) can be sponsored by any of the sponsors at the OTCEI, if they have issued capital of Rs. 30 lakhs and above.

The sponsor-member is also required to give two-way quotes for the scrip (i.e. the price at which they are ready to buy and to sell the security of the sponsored company) for at least 18 months. In addition, there may be another market maker giving two-way quotes for the scrip. The basic objective is to create confidence of the investors in the security and to keep narrow spread between the two prices.

Trading in securities is undertaken through a network of members and dealers who are spread all over the country. Any individual firm or company may be the dealer, who operate OTCEI counter that is linked to the Central OTCEI computer network. They can also perform market making for the companies. The investors can see on the dealer's computer screen the quotations for any security before placing an order. After the order is placed and matched, confirmation slips are generated by the computers, which give full details of the transaction. The OTCEI follows T+5 rolling settlement system for listed securities and weekly settlement system for permitted securities.

Thus, OTCEI provides the companies nation-wide trading of their securities and encourages new and small entrepreneurs in raising funds for their companies. For the investors, there is complete transparency in the deals, transactions are fast, and liquidity is provided by the two-way quotes given by the sponsors.

Besides, the securities which are listed at the OTCEI, (and which cannot be transacted at any other stock exchange) certain shares/debentures listed at other stock exchange and units of UTI and Mutual Funds are allowed to be transacted at OTCEI. These are called **'Permitted Securities'**.

9.9 TRADING IN DERIVATIVES

A significant development in the Indian stock market during recent years (2000-01) has been the introduction of trading in equity derivatives at the stock exchanges. Derivative product which are permitted to be transacted include both *options* and *futures* on both *equity index* and on *individual stocks*. Thus, there are four equity derivative products available in Indian stock markets.

The introduction of trading in equity derivatives was recommended by the L. C. Gupta Committee on derivatives, primarily to provide hedging facility against market risk to the equity holders. Besides, it will also increase the efficiency and liquidity of the cash market in equities through arbitrage transactions.

The term derivative indicates that it has no independence value of its own. Its value is derived from the value of some other asset, particularly a financial asset.

Derivatives are broadly classified into futures and options. **Future Contracts** are agreements to buy or sell a fixed number of a particular security for delivery at a fixed date in the future at a fixed price. It involves a definite purchase or sale at a future date. The price at which the security will be transacted in future is decided at the time of entering the future contract. At National Stock Exchange and Bombay Stock Exchange, future contracts at one month, two-month and three-month period are allowed and the same expire on the last Friday of the month concerned. Both the parties are required to fulfil the terms of the contract.

Options contracts are contracts, which give the holder the right (but not the obligation) to buy or to sell securities at a pre-determined price within or at the end of a specified period. **Expiration date** is the day on which the option contract matures. The right to buy is called the **call option** and the right to sell is called the **put Option**. The price at which an option can be exercised is called the **exercise price.**

The person who buys (a put option or a call option, i.e. the right to sell or to buy respectively) is called the buyer of the option. The other party which provides this option to the option buyer is called the **option writer**. The buyer of option (who is also called as option holder) has to pay option premium to the option writer for acquiring the right. The premium is a one-time outflow for the buyer of options.

The buyer of an option is not under an obligation to buy or sell at the exercise price. He will do so, if it is beneficial to him, otherwise he would like the option to lapse (i.e. he

will not exercise his right to buy or sell). In such cases, he will only loose the premium, which he has paid at the time of entering into the option contract. For example, A buys a call option from X for one share of Y Company at a premium of Rs. 100, with an exercise price of Rs. 4500 with a maturity of one-month. The current market price is Rs. 4200. If a month latter the price of the share goes upto Rs. 4800/-, the buyer will earn a profit of Rs. 200 (i.e. Rs. 4800 – 4500-100), if he chooses to exercise the option. The seller will loose Rs. 200/- . Thus, the risk of the buyer of call option is restricted to Rs. 100/-, which is the amount of the premium paid by him, while his gain will be unlimited (i.e. depends upon the price at the time of maturity of the contract). The risk for the option writer is unlimited while his gain is restricted to the amount of premium received. The premium amount varies according to market conditions.

A derivative trading in India has been allowed in- (i) Index Futures (ii) Index Options, (iii) Individual Futures and (iv) Individual Options at National Stock Exchange and Bombay Stock Exchange. The index used for this purpose is NIFTY and SENSEX. NIFTY is the index of 50 share prices transacted at National Stock Exchange while SENSEX is the index of 30 shares prices transacted at Bombay Stock Exchange. The combined turnover in the four derivative products (stated above) traded at NSE amounted to Rs. 8700 crore, which rose to Rs. 12919 crore in November, 2001.

Check Your Progress 3

1) What is OTCEI? What are its objectives?

....

....

....

2) What do you understand by Derivatives?

....

....

....

3) Discuss the procedure adopted for undertaking a transaction in option.

....

....

....

9.10 LET US SUM UP

The Secondary Market is the market which deals in trading of shares, bonds, debentures and other securities. The floating, subscription and issuing of these securities is also called **'stock market'.** The growth and development of the primary market depends to a significant extent upon the vibrant secondary market.

The market where securities are traded is called **Stock Exchange**. Presently, there are 23 Stock Exchanges in India. Stock Exchanges have two types of trading system:

(i) Traditional trading system and (ii) On-line trading system.

The settlement of transaction in specified securities is done at the end of each settlement period of two weeks. In case of non-specified securities only money part is handled by the clearing house payment. Actual delivery of securities is handled by the members themselves. The carry forward system (badla) has been replaced by the Rolling Settlement System since January, 1998.

Several reforms have been introduced in the area of transfer of shares. These include the introduction of dematerialisation of securities, incorporation of National Stock Exchange in 1992, establishment of over the Counter Exchange of India (OTCEI) under Section 25 of the Companies Act, introduction of trading in equity derivatives at the Stock Exchanges etc.

The derivative trading in India has been allowed both in Index Futures and options and individual futures and options at National Stock Exchange and Bombay Stock Exchange.

9.11 KEY WORDS

Bonds : Bond is a security issued by a company, financial institution or Government, which offers regular payment of interest at fixed rates.

Boom : A condition of the market denoting increased activity with rising prices and higher volume of the business resulting from greater demand of securities.

Broker : A broker is one who performs various functions in organised security markets. He arranges transactions at the stock exchange.

The broker performs all these functions for commission called brokerage.

Buyback : The arrangement agreed to between the company and its investors to buy back the securities for a specific price.

Call Option : The right to buy as above is called call option.

Capital Market : It is essentially the long-term market for securities and loanable funds.

Coupon Rate : It is the rate of interest, which the issuer pays on the principal/paid up value of the bond. It is fixed at the time of issuance of the bond.

Debenture : There is no conceptual difference between a bond and a debenture. The term 'debenture' is generally used with reference to business, trade and industrial loans of the private sector. The term 'bond' is commonly used in connection with borrowing of the public sector including that of the Central Government.

Deep Discount Bonds : This bond is issued at a discount on the face value. The face value is paid at the maturity. These bonds are also known as zero coupon bonds.

Dematerialisation : Securities do not exist in physical form i.e. in the shape of share certificates. Instead of holding of securities by an investor is recorded electronically by the Securities Depository. Any transaction undertaken by the investor is recorded in the books of the Depository and no physical delivery of the security is neither taken nor given.

Derivatives : Derivatives are those products, which have no independent value of its own. It's value is derived from the value of some other asset

underlying it. For example, in case of individual share derivative its value depends upon the value of the share concerned.

Dividend : It is the share of profit that is paid to the shareholders.

Future Contracts : These are agreements to buy/sell a fixed number of a particular security for delivery at a fixed date in the future at a fixed price.

Gilts : Fixed interest rate securities by the government to raise money for public expenditure in India by auction process.

Going Public : It implies that an existing firm becomes a corporation and raises funds from the public through new issues.

Listed Securities : These are those securities that appear on the approved list of a stock exchange. These securities are also called 'quoted' securities.

Options : Option is a contract, which gives the hold the right to buy or to sell securities at pre-determined price within or at the end of a specified period. There is no obligation to buy/sell.

Over the Counter Negotiation : Some times, the transactions in securities are negotiated by a direct interaction between the concerned brokers acting on behalf of the buyers as well as sellers. Such a method of transaction is known as 'over the counter' trading in securities. In this method of transaction, the stock exchange does not pay any role.

Put Option : The right to sell as above is called put option.

Split : Sub division of shares of large denomination into shares of smaller denomination. Also means subdivision of holding.

Stag : An applicant for a new issue of shares that hopes to sell the shares on allotment at a profit once trading commences in the secondary market. A speculator is one who buys and sells stocks rapidly for last profits.

Stock Exchange : It is a recognised organization that supervises the transactions in 'listed' securities only.

Volatility : A measure of the price movement of a security during a specific period.

9.12 SOME USEFUL BOOKS

Auerbunch, R. D. (1983): *Financial Markets and Institutions,* Macmillan Publishing Co. Inc., New York..

Bhole, L. M. (1999): *Financial Institutions and Market,* Tata Mc Graw Publishing Company Ltd., New Delhi.

Gupta, S. B. (1995): *Monetary Economics-Institutions, Theory and Policy,* S. Chand & Company Ltd., New Delhi.

Khan, M. Y. (1985): *Indian Financial System: Theory and Practice,* Vikas Publishing House Private Ltd., New Delhi.

Varshney P. N. and Mittal D.K. (2002 Edition): *Indian Fianncial System,* Sultan, Chand & Sons, New Delhi.

9.13 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Stock Exchange refers to the market where securities are traded. The Securities and Exchange Board of India (SEBI) regulates and controls the Stock Exchanges.

2) Dealings of securities on the trading floor of the Stock Exchanges through the brokers is traditional system at Stock Exchanges.

3) Transaction of securities business through computers (linked with the main computer of the Stock Exchanges through VSATs) by the brokers is called as 'on-line Trading System'. The advantages of on-line trading system are:

   i) Securities market is made more transparent, (ii) Very convenient, fast and efficient, (iii) Easy access to large number of customers/dealers.

Check Your Progress 2

1) Rolling Settlement System refers to a method of settlement of transactions on a voluntary basis on the stock exchanges for securities eligible for demat trading. The advantages of this system are:

   i) speedy disposal of payment and delivery of securities,

   ii) enhancement of efficiency and integrity in the securities market.

2) Dematerialisation of securities means holding of securities only in the recorded forms instead of holding in physical forms i.e. in the form of share/ bond certificates. Its advantages are:

   i) Avoiding the problem of loss in transit, (ii) Getting rid of arbitrary power of the companies in refusing the transfer,

   iii) Solution of the problem of delivery.

3) See Section 9.7

Check Your Progress 3

1) OTCEI, namely Over The Counter Exchange of India (OTCEI) is computerised, screen based, automated Stock Exchange established under Section 25 of the Companies Act. It aims to help the enterprise to set up their projects by raising capital from the market easily and cheaply through sponsorship by a financial institution.

2) Derivatives refer to the products, which have no independent value of its own. Its value is derived from the value of some other asset underlying it.

3) See Section 9.9

UNIT 10 REGULATORY FRAMEWORK FOR CAPITAL MARKET

Structure

10.0 Objectives
10.1 Introduction
10.2 Functions of SEBI
10.3 Powers of SEBI under Securities and Exchange Board of India Act, 1992
10.4 SEBI's Powers Under Securities Contracts (Regulation) Act, 1956
10.5 Organisational Set Up of SEBI
10.6 Guidelines for Disclosure and Investor's Protection
10.7 Free Pricing of New Issues
10.8 Entry Norms for New Issues
10.9 Primary Capital Market Reforms
10.10 Secondary Market Reforms
10.11 Regulation Over Insider Trading
10.12 Regulation Over Security Depositories and Participants
10.13 Substantial Acquisition of Shares and Take-Overs
10.14 Let Us Sum Up
10.15 Key Words
10.16 Some Useful Books
10.17 Answers/Hints to Check Your Progress

10.0 OBJECTIVES

After reading this Unit, you will be able to :

- familiarise yourself with the regulatory framework governing the capital market in India,
- describe the statutory powers vested with SEBI as regulatory authority,
- state the norms for free pricing of new issues and entry for new issues,
- discuss the reforms introduced in the primary and secondary capital market, and
- summarise regulatory measures over insider trading.

10.1 INTRODUCTION

We have learned in Unit 8 and 9 that several reforms have been introduced in both segments of capital market, namely primary market and secondary market. Keeping in view the role and significance of capital market in the economy and the volatile nature of reforms in general, and in the context of globalisation of economy in the particular, the regulation of the capital market is highly needed. Both these segments

and various participants therein are at present within the purview of a single regulatory authority i.e., the Securities and Exchange Board of India (SEBI). SEBI came into existence through a Resolution of the Government of India dated 12th April, 1988. Later, it acquired statutory recognition and status after the enactment of the Securities and Exchange Board of India Act, 1992.

SEBI has been constituted as a corporate body, having perpetual succession and a common seal. It consists of a chairman, two members each from amongst the officials of the Government of India and the Reserve Bank of India, besides two other members appointed by the Government of India.

10.2 FUNCTIONS OF SEBI

SEBI has been designated as the sole regulatory authority over the securities market. It has been entrusted with the duty –

i) to protect the interests of investors in securities,

ii) to promote the development of and securities market, and

iii) to regulate the securities market.

Thus **SEBI** is not only a regulator, but is also a promoter of the securities market. Section 11 (2) of the Act outlines the regulatory activities of the Board as follows:

a) Regulating the business in stock exchanges and any other securities markets.

b) Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisors and such other intermediaries who may be associated with securities markets in any manner.

c) Registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies, and any other intermediaries.

d) Registering and regulating the working of venture capital funds and collective investment schemes including the mutual funds.

e) Promoting and regulating self-regulatory organisations.

f) Prohibiting fraudulent and unfair trade practices relating to securities markets.

g) Promoting investors' education and training of intermediaries of securities markets.

h) Prohibiting insider trading in securities.

i) Regulating substantial acquisition of shares and take over of companies.

j) Calling for information from companies, undertaking inspection, conducting inquiries and audit of the stock exchanges, mutual funds and other persons associated with the securities markets and intermediaries, and self-regulatory organisations in the securities market.

k) Performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act 1956 as may be delegated to it by the Central Government.

l) Levying fees and other charges for carrying out the purposes of Section 11.

m) Conducting research for the above purposes.

n) Calling from or furnishing to any such agencies, as may be specified by the Board, such information, as may be considered necessary by it for the efficient discharge of its functions.

o) Performing such other functions as may be prescribed.

10.3 POWERS OF SEBI UNDER THE SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992

Securities and Exchange Board of India has been conferred the following powers under the SEBI Act:

i) **Power to Grant Registration Certificates to Intermediaries**

Section 12 of the Act provides for compulsory registration of the various intermediaries associated with the securities market. Hence all intermediaries, namely, stock broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment advisor, depository participant, custodian of securities, foreign institutional investor, credit rating agency and any other agency are required to buy, sell, or deal in securities in accordance with the conditions of a certificate of registration granted by SEBI.

SEBI is also empowered to suspend or cancel a certificate of registration after giving the person concerned a reasonable opportunity of being heard.

ii) Registration of Venture Capital Funds and Collective Investment Schemes

The Act requires a certificate of registration to be obtained from SEBI for sponsoring or carrying on any Venture Capital Fund and Collective Investment Scheme including Mutual Fund.

iii) Power to Issue Directives to Intermediaries

The Act confers upon SEBI powers to issue directions to any person or class of persons mentioned in (1) above, or who may be associated with the securities market, if SEBI is satisfied that such directions are necessary –

a) in the interest of investors, or orderly development of the securities market, or

b) to prevent the affairs of any of the above mentioned intermediaries/persons, being conducted in a manner detrimental to the interests of investors or securities market, or

c) to secure proper management of any such intermediary or person.

iv) Power to issue Directions to Companies

For the protection of investors, the Board may specify the matters relating to issue of capital, transfer of securities and other matters incidental thereto, which shall be disclosed by the companies and also the manner in which to be disclosed.

v) Power to Impose Penalties

The Board may appoint any of its senior officers as Adjudicating Officer for holding an enquiry into various defaults and offences under the Act and for imposing penalties. Monetary penalties may be imposed on capital market intermediaries and other participants for a listed range of violations. An Appellate Tribunal may also be set up to hear appeals against the decisions of the adjudicating authority.

vi) Power to Investigate into Irregularities

SEBI possesses the power to investigate into irregularities and for this purpose it may summon the attendance of, and call for documents from all categories of market intermediaries, including persons in the securities market. SEBI is also empowered to issue directions to the aforesaid persons

with a view to protect investors or securing the orderly development of the securities market.

10.4 SEBI'S POWERS UNDER SECURITIES CONTRACTS (REGULATION) ACT, 1956

The following powers vested with the Government under the Securities Contracts (Regulation) Act, 1956 shall also be exercisable by SEBI to ensure more effective protection of the interests of investors and to create an efficient and well regulated stock market:

i) **Recognition of Stock Exchanges**

A stock exchange may be recognised by SEBI, if it is satisfied that –

a) the rules and bye-laws of the stock exchange are in conformity with the conditions prescribed to ensure fair dealings and to protect investors, and

b) the stock exchange is willing to comply with any other conditions which may be imposed by the Government for carrying out the objectives of the Act.

The recognition may be granted subject to imposition of certain conditions also regarding qualifications of members, manner of entering contracts, representation of the government and maintenance of accounts. A stock exchange other than a recognised stock exchange is prohibited to function.

Every recognised stock exchange shall furnish to SEBI periodical returns regarding its affairs. SEBI is also authorised to appoint one/more person(s) to make an enquiry in relation to the affairs of the governing body of the stock exchange or any of its members.

SEBI is authorised to withdraw recognition granted to a stock exchange in the interest of the trade or in the public interest. It may supersede the Governing Body of a stock exchange and may appoint any person/persons to exercise all the powers and perform duties of the governing body. It is authorised to direct a recognised stock exchange to suspend its business for a period upto seven days in case an emergency arises. The period of suspension may also be extended.

SEBI also enjoys the authority to approve the bye-laws of the stock exchange or to make such bye-laws. A stock exchange may also establish additional trading floor with the prior permission of SEBI. The Central Government/

SEBI is authorised to prohibit the sale or purchase of any specified security, except with the permission of the Central Government, in order to prevent undesirable speculation in that security/securities in any state/area.

ii) **Listing of Securities**

Where securities are listed on the application of any person in any recognised stock exchange, such person is required to comply with the conditions of the listing agreement with that stock exchange.

A stock exchange may refuse to list the securities of any public company in accordance with the powers vested in it in its bye-laws. The company may in that case appeal to the Central Government, whose decision shall be final.

10.5 ORGANISATIONAL SET-UP OF SEBI

To exercise its powers and perform its functions, SEBI has set up the following Departments:

i) **Primary Market Department**

This department looks after all policy matters and regulatory issues for primary market, registration, regulation and monitoring of merchant bankers, portfolio management services, investment advisors, debenture trustees, etc.

ii) **Issue Management and Intermediation Department**

This department vets prospectus, letters of offers for public and right issues, coordinates with primary market policy for framing rules, issues guidance notes and clarifications, etc.

iii) **Secondary Market Department** (Policy, Operating and Exchange Administration New Investment Products, Insider Trading)

This department is responsible for all policy and regulatory issues for secondary markets, and new investment products, registration and monitoring of stock exchanges.

iv) **Secondary Market Department** (Exchange Administration, Inspection and Non-Member Intermediaries).

v) Institutional Investment Department (Mutual funds and Foreign Institutional Investment).

This department is responsible for policy, registration, regulation and monitoring of foreign institutional investors, domestic mutual funds, policy and regulation of substantial acquisition of shares.

Check Your Progress 1

1) Give three important regulatory functions and three promotional functions of SEBI as given in the SEBI Act, 1992.

2) Name the intermediaries who are regulated by SEBI under the SEBI Act, 1992.

....

....

....

3) Identify the powers of SEBI to issue directives to the intermediaries and the companies.

....

....

....

4) Explain the provisions regarding recognition of Stock Exchanges by SEBI.

....

....

....

10.6 GUIDELINES FOR DISCLOSURE AND INVESTOR'S PROTECTION

The Securities and Exchange Board of India issued these guidelines in June, 1992 after the Capital Issues (Control) Act, 1947 was repealed. These guidelines, apply to all issues made subsequently. In these guidelines, SEBI has permitted certain categories of companies to fix the premium on new issues of shares themselves. Moreover, the guidelines require the issuer (companies) to disclose full facts and particulars to the intending investors in their offer documents and also prescribe other rules in connection with the issue of shares, which we shall study subsequently.

10.7 FREE PRICING OF NEW ISSUES

These guidelines have categorised the companies going for public issues into three categories. Within each category, companies fulfilling certain conditions are allowed to fix the premium freely and the rest are permitted to issue shares at par only:

i) new companies,

ii) existing private/closely held companies

iii) existing listed companies

i) **First Issue of New Companies**

A new company is one, which has not completed 12 months of commercial operations and its audited results are not yet available. If a new company is set up by entrepreneurs without a track record, it will issue capital to public only at par.

But, if a new company is being set up by an existing company with a five year track record of consistent profitability, it will be free to price its issue, provided the promoting company contributes 50% of the equity of the new company. The issue price is made applicable to all new investors uniformly and the prospectus contains justification for issue price. If more than one company promotes a new company, each of them must fulfil the profitability criterion, i.e., profits must exist in five out of seven preceding years with profits in the last two years.

ii) **First Issue by Existing Closely Held Unlisted Companies**

Such companies with a three year track record of consistent profitability are permitted to freely price the issue of the share and list the securities on the stock exchanges. Three years track record means profits in three out of preceding five years with profits during the last two years prior to the issue. In case of public sector banks, the track record of consistent profitability should be for two years only.

A company which does not have three years track record of consistent profitability, can issue capital to public for raising additional capital only at par provided not less than 20% of the total issued capital (expended capital) is offered to public.

A company without a three year track record of consistents profitability, which has been promoted by other company/ companies with a five years track record of consistent profitability will have the freedom to price the share, provided the promoting company/companies contribute not less than 50% of the total issued capital subject to lock-in-period.

The pricing will be determined by the issuer and the lead managers to the issue and would be subject to specific disclosure requirements including –

a) disclosure of the net asset value of the company as per the last audited balance sheet, and

b) justification for the issue price.

iii) **Public Issue by Existing Listed Companies**

These companies are allowed to raise fresh capital by freely pricing their further issues. The issue price will be determined by the issuer in consultation with the lead managers to the issue. The prospectus or offer document should contain the net asset value of the company and a justification for the price of the issue. High and Low prices of the shares for the last two years should also be mentioned.

10.8 ENTRY NORMS FOR NEW ISSUES

In order to improve the quality of paper entering the primary market, SEBI introduced a very effective regulatory step by prescribing the entry norms for the issuer companies. The guidelines issued by SEBI on April 16, 1996 as subsequently amended, are as follows:

i) No company, intending to get its securities listed on any stock exchange, shall make the first offer to the public of equity or bonds convertible into equity, unless it has a track record of dividend payment in immediately preceding three years. By track record of dividend payment is meant that dividend has been declared in each of the three years.

ii) If the company is a manufacturing company and does not satisfy (i) above, it can make for the first time an offer only if –

   a) a scheduled bank or a public financial institution has appraised the project to be financed through the public issue, and

   b) the bank/public financial institution is partly financing the project by way of loan/equity to the extent of 10% of the project cost.

   This condition has been extended to the services sector also.

iii) An existing company, whose securities are listed on any stock exchange, shall have to satisfy either of the above conditions (i.e. (i) or (ii) above) before the public issue, if its net worth, after the offer to the public, becomes more than five times the net worth prior to such offer.

iv) The above entry norms will not apply to the public sector banks. If they want to issue capital at a premium, two years profitability record will be sufficient as against three years' requirement for others. New private sector banks are allowed issues at par.

In June 2000, the SEBI further tightened the entry norms for IPOs as follows:

a) IPO of size upto 5 times the pre-issue networth is allowed

only if the company has a record of profitability and networth as specified above.

b) Companies without such track record or the issue size beyond 5 times the pre-issue networth are allowed to make IPOs only through the Book Building route and 60% of the issue to be allotted to qualified institutional borrowers.

v) The above entry norms are also not applicable to offer for sale/bought out deals to be listed on the OTCEI, provided these were registered with OTCEI on or before April 16, 1996.

In March 1999, SEBI relaxed entry norm (No. (i) above) by changing the requirement of actual payment of dividend in three years to 'ability to pay dividend' in terms of Section 205 of the Companies Act, 1956. In such cases, an additional requirement has also been prescribed for the companies intending to come out with an initial public issue based on ability to pay dividend i.e., they should have a minimum pre-issue net worth of not less than Rs. 1 crore in three out of the preceding five years, with a minimum net-worth to be met during the immediately preceding two years.

10.9 PRIMARY CAPITAL MARKET REFORMS

Following the acquisition of statutory status by SEBI and enhancement of its powers, the Securities and Exchange Board of India has introduced a number of regulatory measures with the object to reform the capital market and to protect the investors' interest. In this section, we shall deal with the various regulatory steps undertaken by SEBI in the primary new issues market.

i) **Regulation over Intermediaries**

All intermediaries in the primary and secondary markets have been brought under the SEBI's regulatory purview for the first time. SEBI has notified rules and regulations for the intermediaries, namely, merchant bankers, brokers and sub-brokers, portfolio managers, underwriters, registrars, share transfer agents, etc. These rules and regulations prescribe, besides others, for their registration with SEBI, capital adequacy norms, obligations and responsibilities, procedure for inspection by SEBI and action to be taken against defaulting intermediaries. They have to abide by the Code of Conduct prescribed for them.

The multiple categories of merchant bankers have been abolished and replaced by a single category. Moreover, only corporates are allowed to function as Merchant Bankers. Merchant Bankers are permitted to carry out issue

management activity only and are prohibited from undertaking any fund-based activity such as acceptance of deposits, leasing and bills discounting. They are required to acquire a certificate granted by SEBI for carrying on their business. The registration can be suspended or cancelled by SEBI if it decides to do so. Separate rules and regulations have been prescribed by SEBI for registrars to issue and share transfer agents, stock brokers and sub-brokers, portfolio managers, etc. Thus all these intermediaries are within the regulatory supervision of SEBI. The latter is vested with the powers to take action against them if defaults/ irregularities are noticed in their functioning.

ii) **Disclosures in Offer Documents**

To enable the investors to make informed investment decisions based on full transparency of facts, SEBI has issued detailed guidelines for the disclosures of full facts in the Prospectus/offer documents by the issuer companies. The latter are required to disclose all material facts and specify the risk factors associated with their projects, while making public issues. In case of the existing companies, financial performance of the company for the last five years, along with justification of premium and risk factors and management perception of risk factors are also required to be published in the prospectus/offer document.

Though the Public Issue offer document is now not vetted by **SEBI**, a draft prospectus/offer document is filed with SEBI, and it is deemed as a public document. Merchant bankers are required to file its copies with stock exchanges where the shares are proposed to be listed. Copies are also to be made available to the public. Thus the prospectus/ offer document is made available for scrutiny by all concerned before its finalisation. Lead Manager to the issue is required to give a due diligence certificate regarding disclosures made in the offer document. Such certificate will be a part of the offer document itself for better accountability and transparency on the part of the Lead Manager.

iii) **Code of Advertisement**

SEBI has issued a code of advertisement for public issues to ensure that the advertisement is truthful, fair and clear, and does not contain any statement which is untrue or misleading. It shall be the responsibility of the Lead Manager to ensure strict compliance with the code of advertisement by the issuer company.

iv) **Underwriting**

Underwriting of new issues is not mandatory since 1994. If the issue is underwritten, the Lead managers must satisfy

themselves about the net worth of the underwriters and the outstanding commitments and disclose the same to SEBI.

If the issue is not underwritten and the company is unable to collect 90% of the amount offered to the public, or if the issue is underwritten and the company is unable to receive 90% of issued amount from public subscription plus accepted devolvement from underwriters, within 60 days from the closure of the issue, the company shall refund the full subscription amount. Minimum subscription clause is applicable to both public and right issues and not to offer of sale of securities.

v) **Allotment of Securities**

The following rules have been laid down in connection with allotment of securities:

a) The minimum percentage of securities to be issued to the public for the purpose of listing was reduced from 60% to 25%.

b) Allotment procedure was revised to introduce the requirement that shares be allotted on a pro-rata basis.

c) A norm of five shareholders for every Rs. 1 lakh of fresh issue of capital and ten shareholders for every Rs. 1 lakh of offer for sale was prescribed as an initial and continuing listing requirement.

d) Payment of any direct or indirect discounts or commissions to persons receiving firm allotment has been prohibited.

e) The practice of making preferential allotment of shares at prices unrelated to the prevailing market prices has been stopped and fresh guidelines issued by SEBI in this regard. Issue of shares on a preferential basis can be made at a price not less than the higher of the following:

   average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during six months preceding the relevant date

   OR

   the average of the weekly high and low of the closing prices of the share during the two weeks preceding the relevant date.

f) A system of appointing SEBI representatives to supervise the allotment process was introduced to minimise malpractices in allotment of over-subscribed public issues.

g) Public Sector bonds are now within the regulatory authority of SEBI.

Check Your Progress 2

1) Fill up in the blanks:

   i) Under the new guidelines issued by SEBI relating to free pricing of new issues the companies have been divided into .... categories for public issues.

   ii) Existing private companies having .... year track record of consistent profitability are permitted to freely price the issue of share and list the securities on the stock exchanges.

2) State true or false:

   i) All intermediaries in the primary and secondary markets have been brought under the SEBI regulation. (T/F)

   ii) Lead Manager is not required to give a due diligence certificate regarding disclosures made in the offer document. (T/F)

   iii) The minimum percentage of securities to be issued to the public for the purpose of listing has been reduced from 60% to 25%. (T/F)

10.10 SECONDARY MARKET REFORMS

The Securities and Exchange Board of India has undertaken a number of measures for streamlining the functioning of the secondary market. These measures aim at improving market efficiency, making stock market transactions more transparent, curbing unfair trade practices and bringing capital market upto international standard.

i) **Regulation over Stock Exchanges**

As already noted, the Government of India delegated its powers to SEBI to regulate the Stock Exchanges. SEBI directed the Stock Exchanges to broad base their Governing Boards and change the composition of their arbitration, default and disciplinary committees. The Governing Board should comprise of equal number of elected stockbroker directors and SEBI/Government nominees. Representation of stockbroker directors shall be limited to 40 percent on the disciplinary committee.

SEBI has commenced inspecting the affairs of Stock Exchanges and enquiries have been ordered into the affairs of their Governing Boards.

ii) **Capital Adequacy Norms for Brokers**

SEBI has prescribed capital adequacy norms for brokers so as to ensure that such brokers' firms are adequately

capitalised in relation to their outstanding position. These norms prescribe a base Minimum Capital plus additional capital related to the volume of business. Stock Exchanges have amended their bye-laws in this regard.

iii) **Transparency in Client-broker Relationship**

SEBI has made it mandatory for brokers to maintain separate accounts for their clients and for themselves. They must disclose the transactions price and brokerage separately in the contract notes issued to their clients. Brokers must get their account books audited and the audit report filed with SEBI. Contract notes are to be issued within 24 hours.

iv) **Revision of Listing Agreements**

SEBI advised the Stock Exchanges to amend the listing agreements to ensure that a listed company furnishes annual statement to the Stock Exchanges showing variations between financial projections and projected utilisation of funds made in the offer documents and actuals. Thus, the shareholders can make a comparison between promises and performance.

10.11 REGULATION OVER INSIDER TRADING

With a view to ensure fairness in securities trading, and to eliminate the ill effects of insider trading, SEBI framed SEBI (Insider Trading) Regulations in 1992. According to these regulations an insider is prohibited from:

a) dealing either on his own behalf or on behalf of any other person in securities of a company, listed on any stock exchange on the basis of any unpublished price sensitive information, or

b) communicate any unpublished price sensitive information to any person, except as required in the ordinary course of business or under any law, or

c) counsel any other person to deal in securities of any company on the basis of unpublished price sensitive information.

Unpublished Price Sensitive information is defined, as any information, which relates to the following matters and is generally not published by the company for general information, but which, if published or because known, is likely to materially affect the price of the securities in the market.

i) financial results,

ii) intended declaration of dividends,

iii) issue of bonus, right shares,

iv) any major expansion plan/execution of new projects,

v) amalgamations, mergers, take-overs,

vi) disposal of undertaking, and

vii) any change in policies, plans or operations of the company.

An insider is a person who is or was connected with the company and is reasonably expected to have access to unpublished price sensitive information.

Any insider who contravenes any of the above provisions will be guilty of Insider Trading. SEBI has the power to investigate into and inspect the books of accounts, either records or documents of an insider upon receipt of any complaint-alleging insider trading, or upon its own knowledge and information. On the basis of the investigation report, SEBI may give necessary directions to the insider to protect the interest of investors as well as of securities market.

10.12 REGULATION OVER SECURITY DEPOSITORIES AND PARTICIPANTS

The Securities Depositories and the participants have also been brought within the regulatory authority of SEBI. It has made SEBI (Depositories and Participants) Regulations in 1996. The salient features of these regulations are as follows:

i) A securities depository may be sponsored by any one of the followings, namely, a public financial institution, a scheduled bank, a foreign bank, a recognised stock exchange, a financial services company (at least 75% of its capital must be held by the above mentioned institutions jointly or severally), a foreign company providing custodial, clearing or settlement services in securities market and foreign financial services company approved by the Central Government.

ii) The sponsor shall hold at least 51% of the equity capital of the depository. The balance shall be held by participants. No participant shall hold more than 5% of the equity capital of the depository.

iii) A certificate of registration and a certificate of commencement of business must be obtained by the sponsor from SEBI.

iv) The depository must have a net worth of not less than Rs.100 crores and must have established the infrastructure facilities and systems.

v) The participants are required to obtain a certificate of registration from SEBI, which shall be valid for a period of five years and may be renewed thereafter. Besides, the institutions mentioned in (i) above, a clearing corporation (or a clearing house) of a stock exchange, a stock broker (with minimum net worth of Rs.50 lakhs), and a non-banking finance company (with minimum net worth of Rs.50 lakhs) may also apply for registration as participant.

vi) SEBI has the right to undertake inspection of the books of accounts, records, documents, infrastructure, systems and procedures or to investigate the affairs of a depository, a participant, a beneficial owner, an issuer or its agent.

vii) SEBI possesses the power to suspend the certificate of registration granted to a depository or a participant if it contravenes any provision or defaults otherwise.

viii) SEBI may cancel the certificate of registration granted to a depository or participant if:

a) it is guilty of fraud, or has been convicted of an offence involving moral turpitude, or

b) has been guilty of repeated defaults.

SEBI has taken several initiatives to promote dematerialised or paperless trading. SEBI has introduced compulsory trading in shares in dematerialised form in specified scripts by institutional investors (i.e. mutual funds, banks, financial institutions and foreign institutional investors) with effect from January 15, 1998. The list of shares for compulsory dematerialising trading is gradually expanding.

10.13 SUBSTANTIAL ACQUISITION OF SHARES AND TAKE-OVERS

Substantial acquisition of shares and take-over have been brought within the regulatory umbrella of the SEBI. It has issued SEBI (Substantial Acquisition of Shares and Take-over) Regulations, which provide a transparent process to be followed by the acquirer of the shares. Its main objective is to protect the interest of minority shareholders. The main features of these Regulations are as follows:

i) Every shareholder holding more than 10% shares of a company or voting rights or having control over the company shall have to declare to the company the number and percentage of shares held by him.

ii) An acquirer, who wants to acquire shares/voting rights/ control (which alongwith his existing voting rights/shares shall exceed 10% of the shares of the company), shall have to make a public announcement through advertisement in

newspapers to acquire shares. A copy of the public announcement shall be sent to SEBI and all stock exchanges where the shares are listed. A letter of offer shall also be sent to the SEBI, who may suggest changes therein. Thereafter it is sent to the shareholders of the Company concerned.

iii) The offer to acquire the shares shall be made at a minimum offer price, which shall be fixed in the manner prescribed.

iv) The public offer shall be made to the shareholders of the target company to acquire from them an aggregate minimum of 20% of the voting capital of the company.

v) Any other person who is desirous of making any offer shall, within 21 days of public announcement of the first offer, make a public announcement of his offer for acquisition of the shares of the same target company.

vi) Upon the public announcement of the competitive bid/bids, the first acquirer shall have the option to announce:

(a) a revision of the offer, or

(b) withdrawal of the offer with the prior approval of the Board.

vii) By way of security for performance of his obligations under the regulations, the acquirer shall deposit in an escrow account the sum which will be 25%, if the consideration payable is upto Rs. 100 crore and 10% thereafter.

vii) Within thirty days after the closure of offer, the acquirer shall make payment for shares offered for sale.

Check Your Progress 3

1) What do you understand by Insider Trading? What regulation has been imposed on it by SEBI?

....

....

....

2) List three salient features of regulation over securities depositories.

....

....

....

3) Which option can the acquirer have upon the public announcement of the competitive bid?

....

....

....

10.14 LET US SUM UP

The primary market and secondary market and the various participants are regulated by Security and Exchange Board of India (SEBI). It has been given the statutory recognition under Securities and Exchange Board of India, Act, 1992. On the one hand, it protects the interests of investors in securities through various regulatory measure, on the other hand, it also promotes the development of securities market. SEBI has been conferred the powers to grant registration certificates to intermediaries and issue directives to them and the companies. It also has the powers to investigate into irregularities and impose the penalties.

Securities and Exchange Board of India has brought about reforms in the new issues market by issuing guidelines for disclosure and Investor Protection, pricing of new issues by companies, entry norms for new issues. SEBI has also taken various steps for reforms in the primary new issues market. All these measures have been duly discussed.

SEBI has made a number of efforts to reform the secondary market, which include regulation over stock exchanges, prescription of capital adequacy norms for brokers, regulation over insider trading, regulation over depositories and participants and rules for substantial acquisition of shares and take-overs.

10.15 KEY WORDS

Capital Market : Capital market is that segment of the financial market wherein transactions involving long term funds are undertaken. For example, the securities market, where transactions in long and medium term securities are under-taken is known as the capital market.

Closely held company : Closely held company is that company in which the majority of shares are held by a few share-holders.

Entry Norms for new Issues : Securities and Exchange Board of India has prescribed certain conditions to be satisfied by a company before it issues its securities in the primary market. Such conditions are known as Entry Norms for new issues.

Free Pricing of New Issues : The price at which a new security is to be issued to be determined freely by an issuer of a security is called free pricing of new issues. In other words, the premium to be charged is decided by the issuer company itself.

Insider Trading : Insider trading is dealing, either on his own behalf of a company listed on any stock exchange on the basis of any unpublished price sensitive information (i.e. information, if published, is likely to materially affect the price of the security).

Intermediaries : Intermediaries are those persons who are associated with the securities market and act in between the investors and the issuers of securities. They facilitate the securities transactions, for example, merchant bankers, brokers, underwriters, Registrar to an issue, depository participants, etc.

Listing of Securities : When a particular security is approved by the Stock Exchange for being transacted at that Exchange, it is called as listing of the security. The company whose security is listed is called a listed company.

Merchant Bankers : Merchant Bankers are the intermediaries in the financial markets, who render various non-fund based services to their company clients, e.g. management of new issues, syndication of loans, etc.

Mutual Fund : A mutual fund is a collective investment devise established as trusts. Mutual fund collects the

savings of the investors by issuing units under various schemes and invest them in transferable securities in the capital market.

Primary Market : That segment of the capital market in which new securities are issued by the issuer to the investors for the first time.

Scheduled Bank : A bank whose name has been included in Second Schedule to the Reserve Bank of India Act. The bank must satisfy the conditions prescribed in Section 42 of the Reserve Bank of India Act.

Secondary Market : That segment of the capital market in which existing (i.e. already issued) securities are dealt with.

Securities Depository : Securities depository keeps the record of the securities held by investors in dematerialised form, i.e. transactions in securities are recorded in the books itself and physical securities no more remain in existence.

Stock Exchange : Stock Exchange is an organised market for undertaking secondary market transaction in securities.

Underwriters : Underwriters are those intermediaries who take upon themselves the responsibility to subscribe to that portion of the securities issued by a company which remain un-subscribed by the investing public.

10.16 SOME USEFUL BOOKS

Annual Reports of Securities and Exchange Board of India (1996), RBI.

Avadhani, V.A. (1996): *Investment Management.*

Avadhani V.A. (1996): *Investment and Securities Markets in India.*

Economic Survey (Government of India) (Relevant Chapters), 2002.

L.M. Bhole (2000): *Financial Institutions and Markets.* Himalaya Publishers, Mumbai.

Machiraju, H.R. (1998): *Indian Financial System,* Vikas Publishing House.

Report on Currency and Finance (Reserve Bank of India) (Relevant Chapters), 1996.

Sundharam, K.P.M. and Varshney, P.N. (2000): *Banking and Financial System,* Sultan Chand and Sons, Delhi

Taxman (1998): *Companies Act with SEBI Rules/Regulations and Guidelines.*

Varshney P.N. and Mittal D.K. (2002): *Indian Financial System,* Sultan Chand and Sons, Delhi

10.17 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) See Section 10.2

2) Stock broker, sub-broker, share transfer agent, banker to an issue, transfer of trust deed, merchant banker, under-writer, port-folio manager, investment advisor, depository participant, credit rating agencies, foreign institutional investment etc.

3) See Section 10.3 under point 3 and 4.

4) See Section 10.4

Check Your Progress 2

1) (i) three (ii) three

2) (i) True (ii) False (iii) True

Check Your Progress 3

1) Insider trading refers to dealing in securities of a company by a person who is or was connected with the company and having access to unpublished price sensitive information. Such a person is prohibited from dealing in security of a company communicating any unpublished price, and counselling another person who deals in securities on the basis of unpublished price sensitive information.

2) See Section 10.12

3) A revision of the offer or withdrawal of the offer.

UNIT 11 ALL INDIA FINANCIAL INSTITUTIONS

Structure

11.0 Objectives
11.1 Introduction
11.2 Development Banking
11.3 Industrial Development Bank of India
11.4 Industrial Finance Corporation of India Limited
11.5 Industrial Credit and Investment Corporation of India Limited
11.6 Industrial Investment Bank of India Limited
11.7 Small Industries Development Bank of India
11.8 National Bank for Agriculture and Rural Development
11.9 National Housing Bank
11.10 Export-Import Bank of India
11.11 Regulation over Financial Institutions
11.12 Performance of Major Financial Institutions
11.13 Non-Performing Assets
11.14 Let Us Sum Up
11.15 Key Words
11.16 Some Useful Books
11.17 Answers/Hints to Check Your Progress

11.0 OBJECTIVES

After going through this Unit, you would be able to :

- Explain the meaning of Development Banking,
- State an overview of the Financial Institutions in India and their main activities,
- Describe the regulations over the Financial Institutions, and
- Discuss the performance of major Financial Institutions.

11.1 INTRODUCTION

A well-integrated structure of financial institutions has evolved in the country comprising 11 institutions at the national-level and 46 at the state-level. These institutions provide a variety of financial products and services to suit the varied needs of the corporates. The national-level institutions comprise *five All-India Development Banks (AIDBs), three Specialised Financial Institutions (SFIs) and 3 Investment Institutions (IIs). At the state-level, there are 18 State Financial Corporations (SFs) and 28 State Industrial Development Corporations (SIDCs).* The AIDBs are Industrial Development Bank of India (IDBI), Industrial Finance Corporation of India Ltd. (IFCI), ICICI Ltd., Small Industries Development Bank of India (SIDBI) and Industrial Investment

Bank of India Ltd. (IIBI). The SFIs comprise Risk Capital and Technology Finance Corporation Ltd. (RCTC), ICICI Venture Ltd. (erstwhile TDICI Ltd.) and Tourism Finance Corporation of India Ltd. (TFCI). The Investment Institutions are Life Insurance Corporation of India (LIC), Unit Trust of India (UTI) and General Insurance Corporation of India (GIC).

IDBI, IFCI, ICICI, and IIBI provide financial assistance to medium and large industries, whereas SIDBI caters to the financial needs of small-scale sector. AIDBs also undertake promotional and developmental activities. Among the SFIs, RCTC and TDICI provide risk capital, venture capital and technology finance, mostly to start-up companies in the knowledge-based IT and related sectors. TFCI extends assistance to hotels and tourism-related projects. Among the investment institutions, LIC deals in life insurance business, while GIC provides general insurance cover. LIC and GIC deploy their funds in accordance with the Government guidelines. UTI mobilises savings of small investors through sale of units and channelises them into corporate investments mainly by way of secondary capital market operations. Besides, the investment institutions also extend assistance to industry through loans and by way of underwriting/direct subscription to equities and debentures. SFCs provide assistance mainly to small and medium enterprises, while SIDCs cater to medium and large-scale industries in their respective states. Apart from providing financial assistance, SFCs and SIDCs also undertake promotional and development activities.

Reserve Bank of India regulates and supervises All India Financial Institutions. These institutions are IDBI, ICICI Ltd., IFCI Ltd., IIBI Ltd., NABARD, NHB, Exim Bank, TFCI, SIDBI and IDFC. Reserve Bank of India undertakes on-site inspection of these institutions and has also evolved off-site surveillance system through obtaining periodic information.

11.2 DEVELOPMENT BANKING

Development Banks in India came into existence in the Post-Independence era. Prior to Independence, only commercial banks existed which provided the business community with short-term working capital finance The need, therefore, was felt for the establishment of institutions, which could provide medium to long-term finance to industry. The first development bank, set up in India in 1948, was the **Industrial Finance Corporation of India**. Its objective was *"to make medium and long-term credit more readily available to industrial concerns in India, particularly in circumstances where normal banking accommodation was inappropriate or recourse to capital issue method was impracticable."*

Development Banking differs from commercial banking in several ways. Commercial Banking is primarily concerned with short-term lending for financing working capital requirements of a concern. Development banking, on the other hand, is concerned with lending funds for medium to long-term for financing the investments in fixed assets of the company. Commercial banking is security-oriented, while development banking is project-oriented. Development banks also finance large-scale projects jointly with commercial banks. Developments Banks have recently been permitted to grant short-term working capital finance to the corporates. They have entered into various other types of financial activities and have undertaken various financial services as well.

Having discussed the important features of development banks, let us explain in brief the functioning of important development banks in India.

11.3 INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)

Industrial Development Bank of India is one of the four All India Development Banks in India. In addition, it is the apex banking institution in the field of long-term industrial finance and thus, it functions as the principal financial institution for co-ordinating the functions and the activities of other All India Financial Institutions.

IDBI was established in 1964 as a wholly owned subsidiary of the Reserve Bank of India (RBI). In February 1976, it was de-linked from the RBI and its entire share capital was transferred to the Central Government. In March, 1994, the **IDBI** Act was amended to empower **IDBI** to issue its equity capital to the public provided that holding of the Central Government does not fall below 51%. Subsequently, IDBI made its first public issue of equity in July 1995, which was the largest equity offering in the Indian stock market till then. The majority of its shares are still held by the Central Government, though the percentage holding of Government has declined to 72.14%.

As an apex developmental financial institution, **IDBI** provides both direct as well as indirect assistance to large and medium scale enterprises. Direct assistance by **IDBI** constitutes a major part of Bank's total assistance. Direct assistance is provided by way of Project Finance, underwriting and direct subscription to shares and debentures, guarantees for deferred Payments and Equipment Finance Schemes. **IDBI** provides indirect assistance through refinance of Term Loans and Re-discounting of Bills.

Besides the Equity Capital of Rs. 659 crores as on March

31, 1997, **IDBI** relies heavily on borrowings for its requirements of funds. Earlier, it used to borrow funds through Government guaranteed bonds, but of late, it has resorted to borrowings by way of unsecured bonds through public issues or private placement. **IDBI** has raised resources through issue of Certificates of Deposits as well. **IDBI** has been borrowing in the International Capital Markets to meet its requirement of foreign currency funds for the Indian industry. It has obtained lines of credit from multi-national agencies like Asian Development Bank, IBRD, Exim Bank of Japan besides lines of credit from German and French financial institutions. IDBI has also negotiated loans through floating rate notes in the international capital market at competitive rate of interests.

11.4 INDUSTRIAL FINANCE CORPORATION OF INDIA LIMITED

Industrial Finance Corporation of India (IFCI) was the first development bank established in India in the year 1948. It was established as a statutory corporation under the **IFCI** Act, 1948 with the objective of making medium and long-term funds more readily available to industrial concerns in India. **IFCI** was converted into public limited company on July 1, 1993 and is now known as the Industrial Finance Corporation of India Ltd. Every shareholder of **IFCI** became the shareholder of the company with effect from the date. The necessity for **IFCI's** conversion into a limited company was felt to ensure greater flexibility and ability of **IFCI** to respond to the needs of the changing financial system. After its conversion into a public limited company, **IFCI** now has the flexibility to reshape its business strategies with greater operational autonomy and in providing quality services to customers and tapping the capital markets. Under the **IFCI** Act, 1948, **IFCI** was prohibited to enter into the capital market except when backed by a Government guarantee and was thus prevented from raising resources on competitive basis. As a joint stock company **IFCI** is now able to enter the capital market for resources, through debt and equity instruments. After becoming a company, **IFCI** made a public issue of equity shares aggregating Rs. 525 crore during the year 1993-94.

11.5 INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA LIMITED

Industrial Credit and Investment Corporation of India Ltd. (ICICI) was the first development bank set-up as a joint stock company in India in 1955. Though Industrial Finance Corporation of India had already come into existence at that

time, necessity to establish another institution in the private sector was felt primarily to channelise the World Bank funds to the Indian industry and also to build up a capital market in India. Initially, its entire share capital was held by commercial banks and insurance companies and other financial institutions, but with the nationalisation of banks, major portion of its share capital was later held by these nationalised institutions. After the public cum-rights issue of equity capital by **ICICI** in 1991, the number of shareholders of the corporation increased considerably. As on March 31, 2001, its major shareholders were the Unit Trust of India (6.63%), Insurance Companies (23.47%), FIIs and NRIs (15.11%), Corporate Bodies (7.53%), Banks and Financial Institutions (3.11%), Individuals (10.21%). 32.65% of the shares were held by Deutsch Bank as depository for ADRs holders.

The core business activity of the **ICICI** has traditionally been the business of providing project finance. But over the years, it has undertaken many non-projects based activities and has diversified into new but allied activities through the establishment of its subsidiaries. For example, during recent years, **ICICI** has considerably increased the share of corporate lending from 9.1% in 1997 to 39.8% in 2001. Retail banking, i.e. lending for automobiles, homes, etc. now accounts for about 3% of its total loan portfolio. In project financing also, the share of infrastructure project finance has increased at the cost of manufacturing sector project finance, which has declined from 73% in 1997 to 35% in 2001.

Though **ICICI** had entered into varied and diversified financial services through its subsidiaries, a significant step was taken by **merging itself with its subsidiary ICICI Bank Ltd.** The merger became effective from March 30, 2002. Along with **ICICI** Ltd., two of its subsidiaries—**ICICI** Personal Finance Services and **ICICI** Capital were also merged with the Bank. Thus, **ICICI** Bank Ltd. has become the largest bank in the private sector with a balance sheet size of Rs. 104, 000 crore and capital adequacy of 11.44%.

Obviously, the apparent reason for the merger was to emerge as a Universal Bank, i.e. a bank which undertakes all types of banking and financial businesses. Probably, **ICICI** Ltd. realised that the days of specialisation into a specific line of activity (i.e. project finance) were over, as project financing ensures reward over a longer period of time, while commercial banking earns quick return and without much risk. The ICICI Bank Ltd., after merger will have to meet the requirements of Cash Reserve Ratio, Statutory Liquidity Ratio and priority sector lending on the entire liabilities of the merged entity.

Check Your Progress 1

1) Distinguish between Commercial Banking and Development Banking. Who regulates and supervises the development banks?

....

....

....

2) What are the main functions of a Development Bank?

....

....

....

3) What were the reasons for the merger of ICICI Ltd. with ICICI Bank Ltd?

....

....

....

11.6 INDUSTRIAL INVESTMENT BANK OF INDIA LIMITED

Industrial Investment Bank of India **(IIBI)** was originally set-up as Industrial Reconstruction Bank of India under the Industrial Reconstruction Bank of India Act, 1984, as a principal credit and reconstruction agency for industrial revival by undertaking modernisation, expansion, re-organization, diversification or rationalisation of industry. However, with the establishment of the Board for Industrial and Financial Reconstruction **(BIFR)**, the role of **IRBI** as a principal agency for industrial reconstruction was marginalised. Hence, it was considered prudent to convert **IRBI** into a full-fledged all-purpose developmental financial institution. **IRBI** was converted into a Government company under the Companies Act, 1956 and was re-named as Industrial Investment Bank of India **(IIBI)**. This restructuring aims at providing adequate operational flexibility and functional autonomy to meet the challenges of the changing environment.

IIBI undertakes all the functions of a development bank. These functions include providing long/medium-term loan/ assistance to medium and large industrial units, and providing under-writing support to issuing of shares and bonds.

11.7 SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)

Since its inception, the Industrial Development Bank of India functioned as the apex bank in the field of financing all industries including the small-scale industries. But when financing activities of small-scale industries grew significantly, need for a separate apex bank for small-scale industry was felt. The outcome was the establishment of Small Industries Development Bank of India (**SIDBI**), which took over IDBI's financing activities relating to small-scale industries.

SIDBI is the principal institution in the country for promotion, financing and development of industries in the tiny and small-scale sectors. It co-ordinates the functions of other institutions engaged in similar activities. SIDBI undertakes both financing activities as well as promotional activities and provides support services.

SIDBIs financing activities are broadly classified into two categories:

A) Direct Assistance, and

B) Indirect Assistance.

A) **Direct Assistance** : Direct assistance to small industries is provided in the following ways :

a) **Project Financing** : Project finance is provided for setting up of new units and for expansion/diversification/ modernisation/technology up-gradation of existing units.

b) **Equipment Finance Scheme** : Under this scheme, assistance is provided for expansion and modernisation of existing units.

c) **Technology Development and Modernisation Fund Scheme** : Technology Development and Modernisation Fund Scheme is a new scheme of **SIDBI** under which assistance is granted to units belonging to engineering, garments, electrical and electronics, crockery, pottery, etc.

d) **Bill Financing Scheme** : Bill finance accounts for the largest amount of direct assistance granted by **SIDBI**. Bills discounted fall in two categories:

- Direct discounting of usance bills arising out of sale of equipments by manufacturers of machinery/capital goods in the small sector. This enables them to offer deferred payment facilities to their prospective purchasers/users, and

- Direct discounting of short-term bills arising from sale of parts, components, sub-assemblies, accessories and intermediate manufactured by small-scale units and supplied to medium and large industries on credit. The aim of this scheme is to improve the liquidity and cash flow of small units as they receive prompt payment in respect of their supplies made to medium and large companies.

e) **Equity Assistance Scheme** : SIDBI provides equity assistance to different types of companies. It provides lines of credit to merchant bankers to put through bought out deals in respect of their small industrial unit clients. Assistance is provided to small units under National Equity Fund Scheme. Seed Capital is also provided under Mahila Udyam Nidhi Scheme and Scheme for Employment of Ex-Servicemen. Under the National Equity Fund assistance of Rs. 6.8 crore was provided to 730 entrepreneurs during 1995-96 as compared to Rs. 3.1 crore to 536 entrepreneurs during 1994-95.

f) **Venture Capital Assistance** : SIDBI also grants assistance from the Venture Capital Fund. SIDBI also subscribes to the funds of other Venture Capital Companies. The projects for which venture capital assistance is provided by SIDBI are in the high risks, specialised and import substitutive areas. Most of these projects propose to use indigenously developed technology and are promoted by experienced technical entrepreneurs.

B) **Indirect Assistance** : SIDBI grants indirect assistance to industries through

a) Refinance of term loans granted by Banks, State Finance Corporations (SFCs) and State Industrial Development Corporations (SIDCs), and

b) By Rediscounting of bills of small-scale industries.

11.8 NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT (NABARD)

National Bank for Agriculture and Rural Development (NABARD) is the apex financial institution in the area of agricultural finance and rural development. It was set up in July 1982 by merging the Agriculture Credit Department and Rural Planning and Credit cell of the Reserve Bank of India and the entire undertaking of Agriculture Refinance and Development Corporation.

NABARD undertakes the following functions:

i) **Credit to Farm Sector: NABARD** provides financial

assistance to the farm sector by way of refinance for various agriculture and allied activities, like minor irrigation, plantation and horticulture, land development, farm mechanisation, and animal husbandry. The refinance is provided to commercial banks, State Co-operative Banks, Regional Rural Banks and State Land Development Banks. Besides providing refinance, NABARD also provides short-term loans to State Co-operative Banks and Regional Rural Banks for financing seasonal agricultural operation, marketing of crops, purchase of agricultural inputs.

ii) **Developmental Activities**: NABARD undertakes various developmental activities such as formulation of credit plans, building of institutions, promotion of Research and Technology. It also co-ordinates rural credit agencies and develops expertise to deal with agriculture and rural problems.

iii) **Regulatory Function**: The Banking Regulation Act, 1949 has empowered NABARD to inspect the working of the Regional Rural Banks and Co-operative Banks. Its recommendation is required for opening of a new branch before the RBI gives its permission to do so.

11.9 NATIONAL HOUSING BANK (NHB)

National Housing Bank (**NHB**) was set up in July 1988 under the National Housing Bank Act, 1987 as the apex bank in the field of housing finance. It is a wholly owned subsidiary of the Reserve Bank of India. It is the principal agency to promote housing finance institutions at the regional and local levels and to provide financial and other support to such institutions.

NHB has an equity capital of Rs. 300 crores, which is contributed by Reserve Bank of India. NHB also raises resources through a variety of debt instruments such as bonds, debentures and borrowings. Its bonds which are guranteed by the Government of India, are eligible securities for commercial banks for compiling with the staturory liquidity requirement under Banking Regulation Act. Moreover, it receives external assistance also from the international agencies such as USAID, OECF Japan. It accepts deposits through Home Loan Accounts maintained by commercial banks.

National Housing Bank provides re-finance to the Housing Finance Companies, which are spread all over the country and account for the major share, followed by commercial banks and co-operative banks and Land Development Banks.

The eligibility criteria for obtaining refinance from NHB are as follows :

i) The housing finance company must have minimum share capital of Rs. 3 crore and the promoters' contribution of at least 25% of the total capital.

ii) It must be registered as a public limited company. Long-term finance for construction/purchase of houses for residential purposes must account for at least 75% of loans.

iii) It should not be a subsidiary of any construction company. Top management of Housing Finance Company should not hold similar office in Construction Company of the promoters.

National Housing Bank provides refinance to housing finance companies at varying rates depending on the size of the loans. The performance of NHB in terms of refinance provided by it to the Housing finance companies is given below :

Table 11.1 : Refinance provided by National Housing Bank

Year (1)	Disbursement by Housing Finance Companies (2) (Rs. in crores)	Refinance by NHB (3) (Rs. in crores)	(3) as %age of (2)
1990-91	953.9	N.A.	-
1991-92	1237.4	N.A.	-
1992-93	2395.4	N.A.	-
1993-94	2823.2	244.4	8.7%
1994-95	3524.3	275.6	7.8%
1995-96	4399.6	248.4	5.6%
1996-97	4618.7	327.7	7.1%

Source: Annual Report–National Housing Bank
NA = Not available

Thus, though the loans disbursed by Housing Finance Companies have increased by more than 5 times during the six-year period but refinance by NHB constitutes just 7% of the loans disbursed. Almost 90% of the housing loans given by the Housing Finance Companies are out of their own resources.

11.10 EXPORT-IMPORT BANK OF INDIA (EXIM BANK)

Export-Import Bank of India **(EXIM Bank)** was set up in 1982 for the purpose of financing, facilitating and promoting the foreign trade of India. **EXIM Bank** is wholly owned by

the Government of India. It is the apex financial institution in the country for co-ordinating the working of institutions engaged in financing exports and imports. Besides export finance, it also renders various advisory services to exporters and other entities connected with foreign trade.

EXIM Bank has a paid up capital of Rs. 500 crores, which has been contributed by the Government of India. Besides the equity capital, the Bank raises its resources from domestic and international markets, which constitute a significant source of funds. Within the country, its diversified resources base included bonds, fixed deposits, certificates of deposits, borrowings by way of term money. Banks, debt instruments have received 'AAA' ratings from CRISIL and ICRA. Exim Bank has raised foreign currency loans by way of medium-term syndicated loans from international banks. International Finance Corporation has granted it a Line of Credit. Similarly other overseas banks and institutions have sanctioned Import Lines of Credit under which foreign currency has been drawn by **Exim Bank.**

Exim Bank undertakes a variety of lending and service programmes, which are meant for Indian entities, Commercial Banks and Overseas entities. Exim Bank operates a wide variety of schemes for the benefit of Indian exporters. Some of these are as follows :

i) **Export (Supplier's) Credit** : Such credit is granted to Indian exporters to enable them to extend term credit to overseas importers of eligible Indian goods.

ii) **Finance for Consultancy and Technology Services** : Such credit is granted to Indian exporters of consultancy and technology services to enable them to extend term credit to overseas importers.

iii) **Pre-shipment Credit** : Such credit is granted to Indian exporters to enable them to buy raw materials and other inputs for export contracts extending over a period of six months.

iv) **Foreign Currency Pre-shipment Credit** : This is granted to eligible exporters to enable them to access finance for import of raw materials and other inputs needed for export production.

v) **Finance for Export Oriented Units and Units in Export Processing Zones** : This credit is granted to Indian Companies to acquire indigenous and imported machinery and other assets for export production.

vi) **Foreign Currency Lines of Credit for Imports** : Under this scheme, eligible export oriented units get foreign currency loans to acquire imported machinery for export production.

vii) **Overseas Investment Finance** : Such finance is provided to Indian promoters of joint ventures or subsidiary set up abroad. It enables them to financé equity contribution in such ventures. Exim Bank is one of the agencies to carry out technical appraisal to establish viability of overseas projects for approval by Govt./RBI.

viii) **Export Marketing Finance** : Such finance is provided to exporters to implement market development programmes and finance productive capabilities through loan financing. Companies can upgrade their production facilities and implement their strategic export market development plants to penetrate and sustain their presence in industrialised country markets.

ix) **Production Equipment Finance** : Under this scheme eligible export-oriented units are granted loans to acquire equipment.

x) **Programme for Financing Product/Process Quality Certification** : Under this programme, 50% of the.eligible expenditure incurred by corporates to obtain product/ process quality certification is reimbursed.

xi) **Export Vendor Development Finance** : This facility enables the vendors of export-oriented units to acquire plant and machinery and other assets for increasing export capability.

xii) **Export Product Development Finance** : This scheme is meant to enable Indian firms to undertake product development, Research and Development for exports.

Exim Bank provides finance/refinance to commercial banks in India/abroad to enable them to provide finance to Indian exporters/importers from India. These programmes are as follows :

i) **Refinance for Export (Suppliers) Credit** : Under this programme credit is granted by Exim Bank to banks in India to enable them to offer credit to Indian exporters of eligible goods who offer term credit over 180 days to their importers overseas.

ii) **Small Scale Industries Export Bills Re-discounting** : Under this scheme, banks can rediscount with Exim Bank export bills of their Small Scale Industries customers. The usance of the bills should not exceed 90 days.

iii) **Re-finance of Term Loans to Export Oriented Units** : Under this scheme, Exim Bank provides refinance to banks that offer credit to eligible export oriented units to acquire indigenous and imported machinery and other assets for export production.

iv) **Bulk Import Finance** : This scheme is meant to enable banks to offer finance to importers for bulk import of consumable inputs.

v) **Guarantee-cum-Refinance Suppliers Credit** : This scheme is meant to protect the cash flow of the banks and their exporter clients if the overseas buyer defaults. It protects the Bank by not treating the advances as non-performing asset for making provisions.

vi) **Programme for Confirmation of Letters of Credit** : Under this programme the ability of commercial banks in India is enhanced to open Letters of Credit on behalf of their importer customers for importing raw materials and other items.

vii) **Re-Lending Facility** : This facility is granted to the overseas banks. Under this facility, these banks are granted credit by Exim Bank to enable them to grant term finance to their clients for import of eligible Indian goods.

Exim Bank also operates schemes for the benefit of Overseas Entities (Importers/Institutional agencies in the Importers country), which are as follows :

i) **Lines of Credit** : Lines of credit are granted to financial institutions abroad, foreign governments, their agencies to enable them to grant term loans to finance import of eligible goods from India.

ii) **Buyers' Credit** : This scheme enables foreign buyers to import eligible goods from India on deferred credit terms.

As a complement to its financing programmes, **Exim Bank** offers a wide range of information, advisory and support services to Indian companies and foreign entities, which are as follows :

a) Market related information, assistance in evolving marketing strategies, undertaking sector and feasibility studies, and identification of technology supplies, partner search, investment facilitation and development of joint venture in India and abroad.

b) Advisory services, which enable exporters to evaluate international risks, assets and participate in trade and investment opportunities.

Check Your Progress 2

1) Explain the Equity Assistance Schemes and Venture Capital Assistance Scheme of the Small Industries Development Bank of India.

....

....

....

2) Explain functions of NABARD.

....

....

....

3) What is re-lending facility?

....

....

....

4) State whether following statements are true or false:

i) National Housing Bank provides refinance to the Housing Finance Companies at varying rates. (T/F)

ii) NABARD is the Apex Financial Institution in the area of agriculture, finance and rural development. (T/F)

iii) IRBI does not perform all functions of a development bank. (T/F)

11.11 REGULATION OVER FINANCIAL INSTITUTIONS

The Development Financial Institutions constitute an important segment of the Indian Financial System. They provide long-term funds for the development of industries, infrastructure projects and other major activities and thus, help in the growth of the economy. They are basically governed by their own statues and charters—Industrial Development Bank of India by the provisions of IDBI Act, 1964; and the Industrial Finance Corporation of India Ltd., the Industrial Credit and Investment Corporation Ltd. (ICICI) and the Industrial Investment Bank of India (IIBI) by their respective Memorandum of Association and Articles of Association, besides the Companies Act, 1956. Moreover, these financial institutions are also controlled by the regulations made by both the regulators of the Indian Financial System, namely the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI).

Section 45 L of the Reserve Bank of India Act, 1934, extends the supervisory authority of the Reserve Bank over the financial institutions. This section empowers the Reserve Bank of India to :

i) require the financial institutions to furnish to the Bank

information and particulars relating to their business, and

ii) give these institutions directions relating to the conduct of their business as financial institutions.

Vested with the aforesaid powers, Reserve Bank of India has exercised control over the financial institutions through directives or otherwise, as outlined below :

i) **Raising of Resources**

In the matter of raising of resources, financial institutions have to comply with the direction of the Reserve Bank of India, and the Securities and Exchange Board of India (SEBI). Till 1991, these institutions had access to cheap sources of funds—IDBI, along with Export-Import Bank of India and Industrial Investment Bank of India (IIBI) used to receive loans and advances out of the National Industrial Credit (Long Term Operations) Fund of the Reserve Bank of India. The bonds issued by them carried Government guarantee, making them eligible for being subscribed to by commercial banks to meet their statutory liquidity requirement. Both of these sources of raising finance at cheaper cost have been withdrawn since 1991. They are now allowed to raise resource from the capital market through bonds on market-determined terms and conditions without the patronage of government guarantee.

For raising the funds in the capital market through bonds, the financial institutions are required to seek the approval of the Reserve Bank of India. In addition, they have to comply with "Guidelines to Development Financial Institutions for Disclosure and Investor Protections" issued by SEBI in September 1992.

In May 1997, Reserve Bank of India replaced instrument-wise limits fixed for each financial institution with an umbrella limit (i.e. overall limit) for mobilisation of resource by way of term money borrowings, certificates of deposits, fixed deposits, Commercial Paper and inter-corporate deposits. The overall ceiling for the umbrella limit has been fixed at 100% of the net owned funds for each financial institution. Financial institutions are also permitted to accept fixed deposits for 1 to 5 years and issue certificates of deposits for a minimum amount of Rs. 10 lakhs. Rating for the term deposits accepted by financial institutions has been made mandatory effective from November 1st, 2000.

During 1997-78, Reserve Bank of India permitted these institutions to issue bonds with maturity of 5 years and above without its prior approval, but with simple registration with the Reserve Bank, provided the bonds are without options, etc., and carry interest rate not more than 200 basis points (one hundread basic points equal one percent)

above the yield on Government of India securities of equal residual maturity at the time of their issue. All other bond issues are required to be referred to the Reserve Bank for approval. In April 2000, Reserve Bank of India has decided to provide more freedom and flexibility to financial institutions in raising resources through bonds subject to overall limits fixed in terms of net owned funds. At present their total borrowings can be within the ceiling of 10 times of their net owned funds.

A copy of the offer document is to be submitted to SEBI. Lead Manager has to certify that this document is in conformity with the SEBI Guidelines.

ii) **Exposure Norms**

To minimise the risks in term lending, Reserve Bank of India has prescribed the exposure limits for term lending institutions (i.e. IDBI, ICICI, IIBI, Exim Bank and TFCI) and the refinancing institutions (i.e. SIDBI, NHB, and NABARD). Exposure ceiling has been linked to the institution's capital funds. Earlier it was not to exceed 25% of the paid up capital and free reserves in case of individual borrowers and 50% in case of group borrowers. Exposure includes funded and non-funded credit limits, underwriting and other commitments. With effect from September 1997, the group exposure limit was raised to 60% provided that the additional exposure related to infrastructure projects only. Moreover, exposure to any single industry has been prescribed at 15% of institution's loan portfolio. These exposure limits are applicable to Infrastructure Development Finance Company (IDFC) also. With effect form March 2002, the maximum exposure has been reduced to 15% for individual borrowers, 40% for group borrowers and additional 10% for financing infrastructure projects.

iii) **Lending Operations**

Though, the financial institutions enjoy autonomy as regards their lending operations, the Reserve Bank of India has intervened in the matter on a few occasions. It imposed a ban on financial institution on granting bridge loans against expected equity flows/issues, which was subsequently lifted on 23rd January, 1998. Recently, the development financial institutions have been permitted by the Reserve Bank of India to grant short-term loans to the corporates for working capital purposes. Reserve Bank of India has also permitted these institutions to fix their prime lending rates separately for short-term loans.

iv) **Prudential and Capital Adequacy Guidelines**

In March 1994, Reserve Bank of India prescribed prudential guidelines regarding capital adequacy, income recognition,

asset classification and provisioning for the term lending institutions. Subsequently these guidelines were extended to SIDBI, NABARD and National Housing Bank also. These guidelines are similar to those issued to the commercial banks, except for minor changes.

a) **Capital Adequacy Norm**

All India Financial Institutions were required to achieve capital adequacy norm of 8% by March 31, 1996. Capital adequacy norm has been expressed as a percentage of risk weighted assets. In December 1998, the minimum Capital Adequacy Norm for financial institutions, was enhanced to 9% to be effective from March 31, 2000. All the financial institutions except IFCI Ltd., have achieved this norm at the end of March, 2001. Capital funds are divided into two categories i.e. tier I and tier II capital on the pattern of norms for commercial banks.

b) **Income Recognition**

Financial institutions are allowed to treat an asset as non-performing asset (NPA) if interest/principal is overdue for more than 180 days with effect from March 31, 2002. In respect of NPAs the financial institutions should not take interest income, fees or any other charge, unless actually received.

c) **Asset Classification and Provisioning**

The basis of assets classification and provisioning for financial institutions is almost on the same lines, as prescribed for commercial banks.

11.12 PERFORMANCE OF MAJOR FINANCIAL INSTITUTIONS

The following table shows the disbursements by the three All-India Financial Institutions during recent years. ICICI's share has increased while those of other two institutions declined.

Table 11.2 : Disbursements of Major Financial Institutions

Institution	1998-99		1999-2000		2000-01	
	Amount (Rs. in crore)	% age Share	Amount (Rs. in crore)	% age Share	Amount (Rs. in crore)	% age Share
(A) IDBI	14,470	37.6	17,059	37	17,498	33.9
ICICI	19,225	49.9	25,836	55.9	31,965	62
IFCI	4,819	12.5	3,272	7.1	2,121	4.1
Total	**38,514**	**100**	**46,167**	**100**	**51,584**	**100**

Institution	1998-99 Amount	1999-2000 Amount	2000-01 Amount
(B) All India Financial Institutions	56296	67594	72528
(C) A as % of B	68.4	68.3	71.1

Source : Report on Trends & Progress of Banking in India, 2000-01 (Page 113).

It is evident from the table that the three All-India Financial Institutions account for 71% of the total disbursement of All-India Financial Institutions. Even amongst them the share of ICICI Ltd. is predominant and has consistently increased over the last years.

Table 11.3 : Resources Raised by Major Financial Institutions

	Total		ICICI		IDBI		IFCI	
	1999-2000	2000 2001	1999-2000	2000 2001	1999-2000	2000 2001	1999-2000	2000 2001
Public Issue of Bonds	4648 (28.5)	4062 (21.5)	2575 (37.6)	2901 (27.2)	2074 (27.0)	1161 (21.2)	-	-
Private Placement of Bonds	11663 (71.5)	14806 (78.5)	4274 (62.4)	7777 (72.8)	5603 (73.0)	4320 (78.8)	1787 (100)	2709 (100)
Total	**16311**	**18867**	**6849**	**10678**	**7676**	**5481**	**1787**	**2709**

Source : Report on Trend and Progress of Banking in India, 2000-01 (Page 117).

The above table shows that the financial institutions have largely relied on private placement of their bond of debentures and public issues have contributed to a small percentage. IFCI could not make any public issue of its debentures/bonds because of its unsatisfactory financial position.

The three major financial institutions have prescribed their Prime Lending Rates as follows (as on July, 2001):

Table 11.4 : Structure of Lending Rates of Major Financial Institutions

	IDBI	ICICI	IFCI
Long-Term Prime Lending Rate (for term loans exceeding 3 years)	13.5	12.5	13.0
Medium-Term Prime Lending Rate (loans for 1 year-3 years)	12.5	12.5	–
Short-Term Prime Lending Rate (below 1 year)	12.0	12.5	12.5

Source: Report on Trend and Progress of Banking in India, 2000-01 (Page 117).

11.13 NON-PERFORMING ASSETS

The ratio of net Non-performing Assets (NPA) to net loans as on March 31, 2001 was below 10% in respect of ICICI, SIDBI and Exim Bank. But for IDBI, IFCI and IIBI this ratio was as high as 14.8%, 20.8% and 22.9% respectively. These three institutions are thus, suffering from low quality of their loan portfolios, which affect their profitability and solvancy.

Check Your Progress 3

1) Which changes have been made by Reserve Bank of India over raising of resources by Development Financial Institutions?

....

....

....

2) What do you understand by Exposure Norms? Give details of such norms prescribed for All-India Financial Institutions.

....

....

....

3) Fill in the blanks:

a) Capital Adequacy Norms is expressed as a percentage of ....

b) An Asset of a financial institution becomes non-performing if it remains overdue for ....

c) In the total disbursement of All-India Financial Institution, ... is pre-dominated

11.14 LET US SUM UP

A well-integrated structure of financial institutions has evolved over a period of time. All India Financial Institutions include IDBI, ICICI Ltd., IFCI Ltd., IIBI Ltd., NABARD, NHB, EXIM Bank, TFCI, SIDBI and IDFC. Unlike Commercial banks, development banks (IDBI, IFCI, IIBI, SIDBI, and ICICI) deals with lending funds for medium to long-term for financing the investment in fixed assets of the companies.

Industrial Development Bank of India (IDBI) established in 1964 is the apex banking institutions in the field of long-term industrial finance. It provides both direct and indirect assistance to large and medium-scale enterprises. Industrial

Finance Corporation of India Ltd. established as a statutory corporation under the IFCI Act, 1948 has been converted into public limited company with effect from July 1, 1993. It now has greater flexibility for chalking out its strategies in providing quality services to customers and tapping the capital markets.

ICICI, the first development bank set-up as a joint stock company in India in 1955 has been merged with its subsidiaries namely ICICI Bank Ltd., ICICI Personal Finance Services and ICICI capital. It has become the largest private sector bank in the country having capital adequacy of 11.4%.

Industrial Investment Bank of India (IIBI) originally set up as Industrial Reconstruction Bank of India in 1984, has been converted into a Government company under the Companies Act, 1956 as IIBI. It performs all functions of a development bank, like term loan assistance to medium and large industrial units, equipment financing providing underwriting support to issues of shares and bonds.

Small Industries Development Bank of India is the main institution in the country involved in the promotion, financing and development of industries in the tiny and small-scale sectors.

National Bank for Agricultural and Rural Development (NABARD), established in July, 1982, is a specialised financial institution. It is the Apex financial institution in the area of agriculture finance and rural development. It provides financial assistance to the farm activities and undertakes various development activities. It also regulates the Regional Rural Banks and Co-operative banks.

National Housing Bank (NHB) set up in July, 1988, provides financial and other support to the institutions involved in the housing related activities.

Export-Import Bank of India (EXIM) set up in 1982 facilitates and promotes the foreign trade of India apart from export finance who renders various advisory services to exporters and other entities involved in the foreign trade.

The Development Financial Institutions are basically governed by their own status and charters under which they have been setup. Moreover, these financial institutions are also controlled by the regulations of the Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI). For raising resources, they are required to take permission from the Reserve Bank of India.

In the performance of major financial institutions, ICICI's share has predominated during the recent years and its share has consistently increased over the last three years.

IDBI, IFCI and IIBI have been suffering from low quality of their loan-portfolio.

11.15 KEY WORDS

Bridge Loans : These are short-term loans which are granted to the borrowers of term loans by a bank or financial institutions to enable them to meet their immediate needs for funds. These loans are adjusted/repaid when the term loan is disbursed by the financial institutions.

Equity Assistance Scheme : Assistance, which is provided in the form of subscribing to the equity shares of the company.

Exposure Norms : These norms prescribe the maximum amount of assistance that a financial institution is permitted to provide to a single borrower or a group of borrowers. These norms are expressed as a percentage of the paid-up capital and reserves of the institutions.

Floating Rate Notes : These are debt instruments on which variable interest rate is payable. The rate of interest is linked to a benchmark rate of interest and changes with the change in such bench mark rate of interest.

Guarantee for Deferred Payments : In case of sale of capital goods, the seller generally grants credit for several years i.e. the cost of the capital goods is recovered in several instalments. For this purpose they require a guarantee by a bank/ financial institution.

Pre-shipment Credit : The loans which are provided by Commercial Banks to exporters before the shipment of the goods are called pre-shipment credit. These loans enable the exporters to procure, process and pack the goods for exports.

Promoter's Contribution : The cost of the project is financed from different sources e.g. equity, debt, etc. A part of the cost is required to be provided by the promoters of the project. It is called promoter's contribution.

Project Finance : Project finance is the long/medium-term loan assistance provided by a development bank to the industrial undertakings for setting up, expansion or diversification of an industrial unit.

Refinance of Term Loans : Term loans are provided by Commercial Banks and State Financial Corporation to industrial concerns. On the basis of these loans, these institutions can get loans from Industrial Development Bank of India or Small Industries Development Bank of India. Such loans are called Refinance of Term Loans.

Venture Capital : Venture Capital is that capital which is provided by Venture Capital Fund/ Company to an entrepreneur to undertake a new non-traditional venture with high risk and with the prospects of earning high return. This is provided in the form of equity besides loans.

11.16 SOME USEFUL BOOKS

Annual Report of IFCI, IDBI, SIDBI, NABARD, EXIM Bank, National Housing Bank (latest).

IDBI–Report on Development Banking (1998-99).

Machiraju, H.R. (1998): *Indian Financial System,* Vikas Publication, New Delhi.

RBI–Report on Trend and Progress of Banking in India (2000-01).

Sundaram, K.P.M. and Varshney, P.N. (2000): *Banking and Financial System,* Sultan Chand and Sons, Delhi

Varshney, P.N. and Mittal, D.K. (2002): *Indian Financial System,* Sultan Chand & Sons, Delhi

11.17 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Commercial banking provides security oriented, short-term lending for meeting working capital requirements, whereas, development banks provide project oriented, medium and long-term funds for financing the fixed assets of the company.

   The development banks are supervised and regulated by the Reserve Bank of India.

2) The main functions of development banks are:

   i) to provide lending funds for medium and long-term for financing the investments in fixed assets, and

   ii) to undertake promotional and development activities and to provide various other types of financial services.

3) The reason for merger of ICICI Ltd. with ICICI Bank Ltd. was to realise their will to emerge as a Universal Bank, so that it can undertake all types of banking and financial business.

Check Your Progress 2

1) Under Equity Assistance Scheme, equity assistance is provided to small industrial units, clients and assistance is released out of National Equity Fund Scheme, Mahila Udyam Nidhi Scheme and Scheme for Employment of Ex-Servicemen.

   Venture Capital Assistance is provided out of venture capital fund to the projects located in high risks, specialised and import substitutive areas.

2) The functions of NABARD are:

   i) providing credit to various form of agricultural activities,

   ii) undertaking various development activities like formulation of credit plans, building of institutions, promotion of research and technologies,

   iii) regulation of regional-rural banks and co-operative banks.

3) The credit facility extended to the overseas banks for enabling them to grant term finance to their clients for import of eligible Indian goods.

4) (i) True (ii) True (iii) False

Check Your Progress 3

1) Development Financial Institutions have been allowed to raise resources from capital market through bonds. Instrument-wise limits have been replaced by overall ceiling for the umbrella limit at 100% of the net owned funds for each financial institution.

2) Exposure norms refer to regulations prescribing credit limits for term lending institutions and refinancing institutions. With effect from March, 2002, the maximum exposure has been reduced to 15% for industrial borrowers, 40% for group borrowers and additional 10% for infrastructure projects.

3) (a) risk weighted assets (b) 3 years (c) ICICI

UNIT 12 INVESTMENT INSTITUTIONS IN INDIA

Structure

12.0 Objectives
12.1 Introduction
12.2 Life Insurance Corporation of India
12.3 General Insurance Corporation of India
12.4 Insurance Regulatory and Development Authority (IDRA)
12.5 Mutual Funds
12.5.1 Schemes of Mutual Funds
12.5.2 Unit Trust of India
12.5.3 Other Mutual Funds
12.5.4 Governance of Mutual Funds
12.5.5 Investment Restrictions
12.5.6 Performance of Mutual Funds in India
12.5.7 Risk Factors
12.6 Let Us Sum Up
12.7 Key Words
12.8 Some Useful Books
12.9 Answers/Hints to Check Your Progress

12.0 OBJECTIVES

The main objectives of this Unit are to enable you to :

- Explain the role of the Insurance Companies as investment institutions in mobilising savings of the people and employing them for developmental purposes,
- Describe the regulations as applicable to these institutions,
- Discuss the mutual funds, their unit schemes and regulations governing them, and
- State the risks associated with investments in mutual funds.

12.1 INTRODUCTION

We have learned that financial institutions facilitate the process of capital accumulation by transferring resources from savers to investors. Investment institutions have occupied important place in the well-integrated structure of financial institution. These institutions are: Life Insurance Corporation of India (LIC), Unit Trust of India (UTI), and General Insurance Corporation of India (GIC).

Though, the insurance companies are primarily engaged in providing the cover of insurance to the people, they mobilise huge sums by way of insurance premia, which they have to invest on a long-term basis. Thus, insurance institutions

emerge as important investment institutions. In India, the Life Insurance Corporation of India has been the single life insurance institution for over four decades. It has built up investment portfolio of significant magnitude. Similarly, in the field of General Insurance, the General Insurance Corporation of India and its four subsidiaries have been actively building up their insurance business and investing their funds. Recently, the insurance sector—both life and non-life (general) – has been opened to the private sector and a single authority— 'Insurance Regulatory and Development Authority' (IRDA) regulates the entire insurance industry.

Mutual Funds have also emerged in India as an intermediary in mobilising people's savings and employing them in money market and capital market securities. Their activities, including investment of funds, are regulated by the Regulations issued by the Securities and Exchange Board of India (SEBI). In this Unit you will study these regulations and the progress achieved by mutual funds. At the end of the Unit, you will become aware about the risks involved while investing in the mutual funds.

12.2 LIFE INSURANCE CORPORATION OF INDIA

In 1956, the life insurance business was nationalised and a single monolithic organisation—the Life Insurance Corporation (LIC) was established under the Life Insurance Corporation of India Act, 1956. It is wholly owned by the Government of India and undertakes the business of life insurance by offering a variety of insurance policies to various segments of the society. In course of undertaking life insurance business, LIC mobilises savings of the masses and employs them in various types of securities and advances. Thus, with a view to safeguard the interests of the policyholders as well as the national interest, the funds at the disposal of LIC are subject to Government regulations. As per the guidelines issued under section 27A of the Insurance Act, 1938, the accretions to the "controlled funds" of LIC were to be invested as follows:

S.No.	Investment Avenue	Quantum of Investment
(a)	Central Government Marketable Securities	Not less than 20%
(b)	Loans to National Housing Bank including (a) above	Not less than 25%
(c)	Central Govt.& State Govt. securities including Govt. guaranteed securities including at (b) above	Not less than 50%
(d)	Socially-oriented sectors including public sector, co-operative sector, and (c) above	Not less than 75%

In respect of the balance 25% of the accretion to the controlled funds, the Government had stipulated that the quantum of investment should be as follows :

S.No.	Investment Avenue	Quantum of Investment
(a)	Loans against policies within surrender values	8%
(b)	Immovable properties	2%
(c)	Investment in Private Sector	10%
(d)	Surplus Cash Balance	5%

In 1997, the above sub-classification of utilisation of funds was removed and LIC was permitted to invest the entire amount under the ceiling of 25% on the basis of commercial judgement but subject to prudential norms.

Table 12.1 : Investment of LIC as on 31st March 2000

(A)	Investments in India	Rs. crore
I	Loans	
	• State Electricity Boards/Power Corporations	7075
	• State Government For Housing	2705
	• National Housing Bank	1002
	• Apex Cooperative Housing Finance Societies	6371
	• Municipalties/Zilla Parishads/ Water Supply Sewage Boards	2000
	• State Road Transport Corporations	375
	• Companies & Co-operative Societies	2830
	• Power Generation	111
	• On Mortgage of Property under Mortgage Schemes of LIC	1152
	• On Insurance Policies	5020
	• Others	285
	Total	**28,926**
II	**Stock Exchange Securities**	
	• Govt. of India Securities	70,533
	• State Government Securities	11,925
	• Other Government Guaranteed Marketable Securities	3,556
	• Power Generation (Private Sector)	1,368
	• Shares	11,482
	• Debentures & Bonds	15,079
	• Others	90
	Total	**1,14,033**
III	Special Deposits with Central Government	2,042
IV	Other Investments	906
	Total (in India)	**1,45,907**
(B)	**Investments out of India**	**458**
	Grand Total	**1,46,365**

It is to be noted from the above table that the major portion of LIC's funds are invested in Stock Exchange Securities, pre-dominantly in Government guaranteed securities. Corporate securities are accountable for a small proportion of total investment. Amongst loans also, bulk of the assistance has gone to financing housing, electricity generation and water supply. Corporate Sector got an insignificant portion. Thus, at the end of March 2000, the sector-wise break up of investment was as follows:

a) Public Sector	84.2 %
b) Co-operative Sector	1.53%
c) Private Sector	14.27%
	100.00%

12.3 GENERAL INSURANCE CORPORATION OF INDIA

General Insurance Corporation of India (GIC) was formed in 1973 after the nationsalisation of a large number of general insurance companies. GIC has 4 subsidiary companies—National Insurance Company Limited, New India Insurance Company Limited, Oriental Fire and General Insurance Company Limited and the United India Insurance Company Limited. Thus, GIC along with its four subsidiaries provide a wide range of policies aimed at meeting the varied needs of the customers in the area of general insurance. These insurance companies earn their income by way of insurance premia and invest the funds in various types of securities and provide loans to the corporate sector. The investment policy of GIC is governed by the Insurance Act, 1938 and the guidelines issued by the Central Government in this regard. In accordance with the regulations enforced from April 1, 1995 the GIC invested the funds in the following types of securities:

S.No.	Investment Avenue	Quantum of Investment
(a)	Central Government Securities	Not less than 20%
(b)	State Govt. Securities & other Government guaranteed securities including (a) above	Not less than 30%
(c)	Housing Loans	Not less than 15%
(d)	Market Sector	Not more than 55%

Thus, GIC was allowed to invest 45% in socially oriented sector, and the balance 55% in the market sector.

12.4 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

Government of India has recently opened the Insurance Sector to the private sector. After the enactment of Insurance Regulatory and Development Authority Act, 1999, **IRDA** was set up on April 19, 2000, to –

i) protect the interest of the policy holders, and

ii) regulate, promote and ensure orderly growth of the insurance business.

Reserve Bank of India has issued guidelines to permit the banks and non-bank finance companies business, which have –

i) net worth of not less than Rs. 500 crore in the insurance sector,

ii) Capital Risk Adjusted Assets Ratio (CRAR) not less than 10%,

iii) reasonable level of non-performing assets,

iv) continuously net profit for the last three years, and

v) a satisfactory track record of the performance of the subsidiaries.

Such institutions are permitted to set-up joint venture companies for insurance business with risk participation.

It has granted certificates of registration to 10 life insurance companies and 6 general insurance companies. Twelve companies have already commenced business.

The **IRDA** has issued Investment Regulations for both Life Insurance and General Insurance Companies in 2001. The main points of these guidelines are as follows:

i) **Life Insurance Business**

Funds relating to pension, general annuity business and unit linked life insurance business are to be kept separate from the controlled funds of the insurance company. The controlled funds shall be invested in the following manner :

(a)	Government Securities	25%
(b)	Government Securities or other approved securities including above, not less than	50%
(c)	Approved Investments I Infrastructure and Social Sector, not less than II Others (to be governed by exposure norms) not exceeding	 15% 35%

Infrastructure and Social Sector are defined in the separate Regulations framed by IRDA. Other investment shall be governed by Exposure Norms. Investment in other than approved investments can, in no case, exceed 15% of the fund.

Detailed exposure norms for investments in equity, debentures, terms loans, etc. have been prescribed.

It is to be noted from the above regulations, that while investment in Government and other approved securities continue to constitute 50% of the controlled funds, the remaining 50% will be distributed over :

a) Infrastructure Sector
b) Social Sector including Rural Sector
c) Investment in Securities of all India Financial Institutions
d) Deposits with banks
e) Commercial Paper
f) Treasury Bills
g) Approved Investments under Section 27 A

Thus, in the new regulations, emphasis is laid on insurer's obligation towards rural and social sectors. Investments in the private sector companies, though permitted, will be subject to exposure limits.

ii) **General Insurance Business:** General Insurers will keep invested their total assets in the following manners –

a) Central Government Securities : Not less than 20%

b) State Government securities and other Government guaranteed securities including (a) above : Not less than 30%

c) Housing Loans to State Government For housing and fire fighting equipment : Not less than 5%

d) Investments in approved investments

I Infrastructure and Social Sector : Not less than 10%
II Others (to be governed by exposure norms) : Not less than 55%

Investment in other than approved investments can, in no case, exceed 25% of the assets.

Check Your Progress 1

1) Name the major sectors in which Life Insurance Corporation's funds are invested.

....

....

....

2) State the objectives behind setting up IRDA.

....

....

....

3) State whether following statements are true or false:

   1) Out of the total controlled funds of the insurance companies, 30% are required to be invested in Government securities. (T/F)

   2) As per IRDA regulations, investment in the private sector companies is subject to exposer norms. (T/F)

12.5 MUTUAL FUNDS

A Mutual Fund is an investment vehicle, which collects the savings from the surplus units by floating various unit schemes, and invests the amount so collected in the securities of industrial enterprises. Thus, a Mutual Fund collects the savings of investors who are not able to directly invest their savings into industrial securities and then invests the aggregate funds into securities, which have been thoroughly researched. Mutual Funds therefore, provide the advantage of professional management for the savings of the small investors besides diversification of risks as the funds collected are invested into large number of securities and other instruments.

12.5.1 Schemes of Mutual Funds

Mutual Funds are permitted to float different Unit Schemes with different objectives. For example, one of the objectives of the schemes may be to provide regular income or utmost liquidity or capital appreciation, etc. Mutual Funds in India have introduced a large number of Unit Schemes. At the end of March, 2001, there were 65 Unit Schemes floated by public sector mutual funds (excluding UTI), while 158 schemes were floated by private sector mutual funds. These schemes are broadly classified into two categories as follows :

1) **Closed-end Schemes** : The schemes which are open for

public subscription for a definite period, say 2 or 3 months, are called closed-end schemes. Whatever funds are collected by the schemes during that period constitute the corpus of the scheme, which remains the same. Such, schemes have definite maturity period, say 5 or 7 years, after which they stand terminated. Mutual Funds redeem the units at the prevailing NAV by liquidating the securities in which they had invested the funds of the scheme. The units of the closed-end schemes are transacted at the stock exchanges.

2) **Open-end Schemes** : Open-end Schemes are those, the subscription for which from the investors is solicited on a continuing basis. The investors can join the schemes at any time they like. The corpus of the scheme varies over time due to ongoing purchases and redemptions. There is no time for maturity of the scheme.

In case of open-end schemes, the Mutual Fund provides liquidity to the investors by re-purchasing the units at a price linked with NAV. Sometimes, the closed-end schemes are either extended or rolled over i.e. continued for another period, some of them have been later on converted into open-end schemes.

The open-end schemes can be wound up if the total number of units outstanding (after repurchases) fall below 50% of the original number of investors.

Types of Schemes

Some important types of Unit-Schemes floated in India are as follows:

1) **Income Fund** : Its objective is to earn optimum returns and maintain a balance of safety, yield and liquidity. The investments are made largely in fixed income securities.

2) **Growth Fund** : Its objective is to generate long-term capital appreciation from a portfolio which is invested in equity and equity related instruments.

3) **Balanced Fund** : Its objective is to generate capital appreciation along with current income. The investments are made in combined portfolio of equity and equity related instruments and debt and money market instruments.

4) **Liquid Fund** : It provides income consistent with a high-level of liquidity. Portfolio comprises of money market and debt instruments.

5) **Gilt Fund** : Its objective is to generate credit risk-free returns by investing in Central Government and/or State Government securities.

6) **Tax Saving Plan** : It provides tax relief to the investors. Its objective is to generate long-term capital appreciation. It invests in equity and equity related instruments. There is a lock-in period for the units under this plan i.e. the units cannot be sold till the completion of the lock-in period, say 2 or 3 years.

7) **Index Fund** : This is also a growth fund but it is linked to a specific index of share prices. It means that the funds are invested principally in the securities of companies whose securities are included in the index concerned. Thus, the funds performance is linked to the growth in the concerned index. e.g. NIFTY.

8) **Sector Fund** : It is also a variant of Growth Fund. Under it, funds are invested in equity or equity related instruments of a selected sector, e.g. technology, pharmaceuticals, etc.

12.5.2 Unit Trust of India

Unit Trust of India (UTI) was the first Mutual Fund set up in India way back in 1964, under the Unit Trust of India Act, 1963. It has been given a special status as it has been set up under a separate Law of Parliament and not as a company.

Its initial capital Rs. 5 crore was contributed by IDBI, LIC, SBI and its subsidiaries and other Scheduled banks. UTI is managed and controlled by a Board of Trustees. Its Chairman is appointed by the Government of India, while four trustees and the Executive Trustee are appointed by IDBI. Other contributors to the initial capital appoint the remaining trustees.

Unit Scheme, 1964 is the oldest and biggest Unit Scheme of the UTI. It is an open-end scheme. Its provisions are incorporated in the UTI Act itself. Besides this scheme, the UTI has introduced a large number of Unit Schemes– both open end and closed end– to mobilise the savings of different classes of investors. These schemes have different investment objectives. As on June 30th, 1998, 79 Unit Schemes were in operation consisting of 28 open-end schemes and 51 closed end schemes. Thus, Unit Trust of India has mobilised the largest amount from unit holders among the Mutual Funds and is the biggest Mutual Fund in India.

Unit Scheme, 1964

The UTI sells units under this scheme throughout the year except in the month of June at a price determined by it. It also repurchases these Units from the unit holders at a re-purchase price, also determined by it. In July, every year UTI announces conscessional sale and repurchase prices, which are increased continuously during the subsequent

months. The UTI Act lays down the formula for determining these prices, which have not been exactly Net Asset Value (NAV) based till recently. Thus, UTI has been authorised to fix these prices deviating from the basic principle of NAV based pricing.

Since its inception, the UTI commanded utmost public confidence. It gradually raised the rate of dividend on US 64 from 6.10% in 1964-65 to 26% in 1991-92 to 1994-95.

Crisis in US 64

Towards the end of September 1998, **US 64** faced a serious crisis, when it was reported that **US 64's** balance sheet carried negative reserves of Rs. 1098 crores as on June 30th 1998. Thus, it was realised that the net asset value of the Units was below par, while it was selling new units at Rs. 14 per unit. This led to heavy risk for redemption of units by the unit holders and at the same time also resulted in panic selling of equity shares, as large-scale off-loading of shares by UTI was expected. Sensex declined by 220 points in a few days. UTI, however, faced the situation with the financial assistance from the Reserve Bank of India.

Causes of Crisis

A Committee under the Chairmanship of Shri Deepak Parekh investigated the causes of the crisis, which are summarised below:

i) The proportion of equity in the investment portfolio of US 64 increased considerably from 21% in 1986 to 63% in 1998. The share of interest income in the total income of UTI, therefore, fell considerably. Hence, UTI had to sell good quality shares to book profits in order to meet dividend obligation. Consequently, the quality of the residual equity with the UTI deteriorated considerably. Moreover, it invested in many low quality equity issues.

ii) As already noted, the sale and repurchase prices were set by UTI without any regard to the Net Asset Values of underlying securities. Thus, whenever the share prices fluctuated, the unit prices remained unaffected, primarily to retain investor's confidence.

iii) UTI followed the policy of distributing dividends at gradually increasing rates since inception. During 1995-97, UTI preferred to draw on reserves to maintain dividends rather than to reduce the dividend rate.

By implementing the major recommendations of the Deepak Parekh Committee Report, the UTI felt some improvement in its financial position and it declared a dividend of 13.5% in 1998-99, which was mainly through booking profits by selling

equities. NAV of the **US 64** also improved. But in July 2001, US 64 suffered another major crisis. The Unit Trust of India, slashed the rate of dividend to 10% from 13.5% in the previous year and suspended the sale and repurchase of units for six months till December 2001. Trading in US 64 units was allowed at the National Stock Exchange only.

The deterioration in the financial health of **US 64** scheme was due to several factors, namely–

i) Equity market suffered set back from the beginning of 2001, share prices went down by 25%.

ii) UTI faced heavy redemption of Units in April and May, 2001 at the prevailing repurchase price, while the NAV was much lower.

iii) With the decline in share price, capital gains could not be attained, to the desirable extent, to distribute dividend.

iv) Reserves of **US 64** consequently turned negative.

A bailout package for small investors was announced in July, 2001. Unit holders with holding of upto 3000 units were allowed the repurchase facility at Rs. 10/- per unit from August 1st, 2001. This repurchase price was increased by 10 paise per unit every month till it reaches Rs. 12/- in May 2003. Later on, this special repurchase facility was permitted for holders of upto 5000 units.

From January 2002, **US 64** has been made NAV linked scheme. Investors upto 5000 units are permitted to sell either at the above-mentioned assured repurchase price or at NAV linked price, whichever is higher. But units above 5000 are to be sold at NAV linked price from January 2002.

NAV of **US 64** has remained below par. These units were transacted at National Stock Exchange at Rs. 8.25 per unit on July 24, 2001. This price increased to Rs. 9.30 per unit on August 8th, 2001. The NAV has fallen considerably to approximately Rs. 6.50 recently.

The present financial position of UTI is far from being satisfactory. For the first time in its 38 year old history, it has declared no dividend for the year 2001-02. The Government has been providing budgetary support to unit holders to the extend of the gap between NAV and the assured repurchase price as announced on July 15, 2001. If dividend was declared, it would have increased the gap between the NAV and the special repurchase price and consequently the budgetary commitment of the Government.

UTI is also experiencing short-fall in the monthly income plans maturity in June and August 2002. It has tied up

with State Bank of India for a line of credit of Rs. 1000 crore, with a guarantee from the Central Government. The short-fall would be met through the UTI's Development Reserve Fund.

The UTI is thus, surviving on Government support and bank borrowings. The pioneering investment institution is in such a deplorable state of affairs. How far will it fulfil its commitments and obligation, only the future will reveal.

At present the UTI has over 58 NAV-linked schemes. Apart from **US 64** scheme, all other schemes are SEBI compliant through a voluntary agreement. Even **US 64** has become SEBI compliant to the extent that it has been NAV linked since January 1st, 2002. The Government intends to restructure UTI by repealing the Act and bringing the UTI directly under the purview of SEBI Act.

12.5.3 Other Mutual Funds

UTI enjoyed the monopoly position until 1987 when mutual funds were allowed to be set-up in the public sector. Leading public sector banks – State Bank of India and Canara Bank set up their mutual funds, followed by other nationalised banks such as Punjab National Bank, Bank of India and Indian Bank, Life Insurance Corporation and General Insurance Corporation also set up their Mutual Funds. In 1993, Mutual Funds were permitted to be set up in the private sector also. This liberalisation induced a large number of private companies including foreign mutual funds to float mutual funds in India.

12.5.4 Governance of Mutual Funds

Mutual Funds are governed by SEBI (Mutual Fund) Regulation Act, 1996. The Securities and Exchange Board of India has issued guidelines for the all-round development and regulation of Mutual Fund Industry.

The salient features of these regulations are as follows :

1) **Registration of the Mutual Fund** : A Mutual Fund can be set up only after a Certificate of Registration has been obtained form SEBI on an application made by its sponsor.

2) **Sponsor** : Sponsor is an entity that establishes mutual fund. The sponsor is required to have a sound track record and general reputation of fairness and integrity. The sponsor should be carrying on business in financial services for a period of not less than five years, its net worth is positive in all the immediately preceding five years and has earned profits in three out of the immediately preceding five years including the 5th year.

3) **Trustees** : A Mutual Fund shall be constituted as a Trust and the Trust Deed should be registered under the Indian Registration Act, 1908. A person eligible for appointment as a trustee should be a person of ability, integrity and standing. At least 50% (now 2/3rd) of the trustees should be independent trustees not associated with sponsors. The role of trustees is to supervise and monitor the activities of the Assets Management Company. The trustees and the Asset Management Company should enter into Investment Management Agreement.

4) **Asset Management Company** : An Asset Management Company (AMC) should be appointed by the Sponsor or the Trust, if so authorised by the Trust Deed. The Board of Directors of the Asset Management Company should have at least 50% of the Directors who are independent of the Sponsors or the Trust. The Asset Management Company cannot undertake any other business activity except in the nature of management and advisory services.

5) **Custodian** : The Mutual Fund should appoint a custodian to carry out the custodial services for the schemes of the fund.

6) **Offer Period** : Any scheme of a Mutual Fund should remain open for subscription for a maximum period of 45 days. The AMC should specify the minimum subscription amount, it seeks to raise under the schemes and the extent of over-subscription it intends to retain, in case of over-subscription.

7) **Pricing of Units** : The Mutual Fund should calculate the net asset value of each scheme and publish the sale and repurchase price of the units at least once a week, in case of open ended funds. The Mutual Funds also ensure that the repurchase price is not lower than 93% of the Net Asset Value and the sale price is not more than 107% of the Net Asset Value. In case of close-ended schemes, the repurchase price should not be less than 95% of the Net Asset Value.

8) A copy of the offer document for any scheme of the Mutual Fund has to be filed with SEBI, which can suggest modifications in the schemes in the interest of investors.

9) The advertisement in respect of each scheme shall be in conformity with the advertisement code prescribed by SEBI.

10) Mutual Funds are required to invest their funds in transferable securities in the money market, or in the capital market or in privately placed debentures or securitised debts. Investments should be made subject to the investment restrictions specified in the Regulations.

11) Mutual Funds are permitted to borrow to meet temporary

liquidity needs for the purpose of re-purchase, redemption of units or payment of interest or dividend to the unit-holders. Such borrowings shall not exceed 20% of the net assets of the scheme and the duration of borrowing shall not exceed 6 months.

12) SEBI has specified the valuation norms according to which every Mutual Fund shall carry out valuation of its investments and publish the same.

13) SEBI is authorised to undertake inspection of the books of accounts, records, infrastructure, systems, etc. and to investigate the affairs of a Mutual Fund, the trustees and Asset Management Company. SEBI may appoint an auditor also for these purposes.

14) SEBI is authorised to suspend a certificate granted to a Mutual Fund if it contravenes any of the provisions of the SEBI Act and the Regulations or otherwise fails/defaults in meeting its obligations.

15) SEBI can also cancel the Certificate of Registration granted to a Mutual Fund, if the Mutual Fund –

    a) is guilty of fraud, or has been convicted of an economic offence,

    b) has been guilty of repeated defaults,

    c) the Mutual Fund, Asset Management Company (AMC), Trustee of the Mutual Fund indulges in price manipulation or price rigging or cornering activities affecting the securities market and the investor interest,

    d) financial position of the Mutual Fund deteriorates so that its continuance is not in the interest of unit holders and other mutual funds.

16) SEBI is also empowered to take action for suspension or cancellation of registration of an intermediary holding a Certificate of Registration, who fails to exercise due diligence or comply with the obligations under the Regulations.

12.5.5 Investment Restrictions

Mutual Funds invest the funds mobilised from the investors in Capital Market and Money Market securities. The selection of the securities depends upon the investment objectives of respective Unit Schemes. For example, the growth schemes largely aim at capital appreciation, along with reasonable income. Thus, funds under such schemes are largely invested in equities.

Securities and Exchange Board of India (SEBI) has prescribed the following investment restrictions for Mutual Fund:

1) All the investments of the Mutual Funds will be in transferable securities (whether in the Capital Market or Money Market) or bank deposits or in money call or in privately placed debentures and securitized debt.

2) No loans for any purpose can be granted.

3) Under all its schemes, a Mutual Fund will not own more than 10% of any company's paid up capital carrying voting rights.

4) Each scheme shall not invest more than 15% of its Net Asset Value (NAV) in debt instruments issued by a single issuer, which are rated not below investment grade by a credit rating agency. Such investment may be extended to 20% of the NAV of the scheme with the prior approval of the Trustees and the Board of the AMC. Such limit will not apply to investments in Government securities and money market instruments.

5) Investments within the above limit can be made in mortgage backed securtised debts, which are rated not below investment grade by a credit rating agency.

6) Each scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer. Total investment in such instruments shall not exceed 25% of the NAV of the scheme.

7) Till the funds are deployed as per the investment objective of the scheme, moneys under the scheme may be invested in short-term deposits of scheduled commercial banks.

8) No scheme of the Mutual Fund shall make any investment in :

   a) any unlisted security of an associate or group company of the sponsor, or

   b) any security issued by way of private placement by an associate or group company of the sponsor, or

   c) the listed securities of group companies of the sponsor which is in excess of 25% of the net assets.

9) No scheme of the Mutual Fund shall invest more than 10% of its NAV in the equity shares or equity related instruments of any company.

10) Each scheme shall not invest more than 5% of its NAV in the unlisted equity shares or equity related instruments.

11) Transfer of investments from one scheme to another scheme in the same Mutual Fund shall be allowed if –

   a) Such transfers are made at the prevailing market price

for quoted securities on short basis.

b) The securities so transferred shall be in conformity with the investment objective of the schemes to which such transfer has been made.

12) The fund may buy or sell securities on the basis of deliveries and shall not make any short sales or engage in carry forward transaction or badla finance. Derivatives transaction in a recognised stock exchange is permitted for the purpose of hedging and portfolio balancing.

Check Your Progress 2

1) Distinguish between–

a) Closed-end Schemes and Open-end Schemes

....

....

....

b) Index Fund and Sector Fund

....

....

....

2) Explain the following:

a) Asset Management Company

....

....

....

b) Sponsor

....

....

....

3) Fill in the blanks:

a) The Mutual Funds are allowed to invest not more than .... of its NAV in equity shares or equity related instruments of a company.

b) Each scheme shall invest not more than .... of its Net Asset Value in unrated debt instruments of a single issuer.

c) Transfer of securities from one scheme to another is permitted at .... for quoted securities.

12.5.6 Performance of Mutual Funds in India

Till 1993, there were 7 Mutual Funds, all in the public sector, which had launched 116 schemes mobilising Rs. 8,011 crores from the market. Since then the number of Mutual Funds operating in India has grown up to 27, with Mutual Funds being allowed to be set up by private sector companies including foreign companies. The total number of schemes floated by these funds increased to 196 and the funds mobilised to Rs. 13,890 crores till 1995-96.

The cumulative resources mobilised by Mutual Funds in India till 1995-96 are shown in the following table:

Table 12.3 : Sector-wise Funds Raised by Mutual Funds (1986-87 to 1995-96)

Year (upto)	Public Sector	Private Sector	Sub Total	UTI	Total
1986-87	-	-	-	4563.68	4563.68
1987-88	-	-	-	6738.81	6738.81
1988-89	1621.00	-	1621.00	11834.65	13455.65
1989-90	1460.00	-	1460.00	17650.92	19110.92
1990-91	1683.97	-	1683.00	21376.48	23060.45
1991-92	5674.51	-	5674.51	31805.69	37480.20
1992-93	8011.21	-	8011.21	38976.81	46988.02
1993-94	8407.21	916.00	9323.21	51978.00	61301.21
1994-95	10550.21	3000.00	13550.21	61500.00	75050.21
1995-96	10667.00	3223.00	13890.00	66700.00	80590.00

Source : Mutual Funds Report, Securities & Exchange Board of India, 1996

Table 12.4 : Resources Mobilised by Mutual Funds 1997-98 to 2000-01 (Rs. in Crore)

Mutual Funds	1997-98	1998-99	1999-2000	2000-01
I Bank sponsored	236.89	-88.34	155.58	348.23
• SBI MF	190.11	-71.79	477.60	351.88
• Canara Bank MF	46.78	-16.55	-361.63	-5.41
• Indian Bank MF	-	-	-	-
• Bank of India MF	-	-	-	-
• PNB MF	-	-	40.72	2.12
• Bank of Baroda MF	-	-	1.71	0.36

.....continued

continued........				
II FI-s Sponsored	203.39	546.81	357.41	1274.51
• GIC MF	-19.20	-12.05	-206.28	-41.81
• LIC MF	99.75	348.36	284.52	566.00
• IDBI MF	122.84	210.50	279.17	750.32
• Unit Trust of India	2875.00	2060.90	4548.00	1990.00
III Private Sector MFs	748.62	2060.90	14892.17	9717.35
Total	**4063.90**	**2695.37**	**19953.16**	**13339.09**

Source : Report on Trends & Progress of Banking in India 2000-01.

12.5.7 Risk Factors

Investment in the Units of the Mutual Funds is not without inherent risks. Mutual Funds invest in transferable securities at current market prices, which may vary over a period of time. This results in the variation in the Net Asset Value (NAV) of the units. NAV of the Units of the schemes is computed as follows :

NAV (Rs.) : Market or fair value of securities investments + current assets — current liabilities and provisions

= No. of outstanding units under the scheme

The Fund values its investments according to the valuation norms, as specified in SEBI regulations.

NAV is calculated at the close of every business day. NAV is significant to the investors because redemption (or repurchase) of the units by the Fund depends upon the NAV. Sometimes, an exit load is also charged on redemptions. Exit Load means that a small amount, ½ say or 1 per cent is deducted from the NAV while making repayment to the investors.

Following risks are involved in investing in Mutual Funds :

1) Mutual Funds and securities investments are subject to market risks. There is no assurance or guarantee that the scheme's objectives (e.g. capital appreciation or regular return) will be achieved.

2) The Net Asset Value of units may go up or go down depending on various factors and forces affecting the capital markets. Thus, the redemption value of the units will also change accordingly.

3) Past performance of the Mutual Fund does not indicate future performance.

4) The sponsor is not responsible or liable for any loss or shortfall resulting from the operations of the scheme, except up to the initial contribution towards the setting up of the Mutual Fund.

5) Investors in the schemes are not being offered any guarantee or assured return.

Check Your Progress 3

1) List any three risks involved in investing the Mutual Funds.

....

....

....

....

2) What has been the performance of private sector Mutual Funds in raising resources during recent years?

....

....

....

....

12.6 LET US SUM UP

Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and Mutual Funds are premier investment institutions. Although the main task of insurance companies is to provide insurance cover to the people, yet they mobilise huge sums of insurance premia, which is invested on long-term basis.

LIC established in 1956, under the Life Insurance Corporation of India Act, 1956, is wholly owned by the Government of India and undertakes the business of life insurance by offering a variety of insurance policies to various segments of the society. It mobilises savings of the masses and invests its funds in various types of securities and advances under the guidelines issued under Section 27 A of the Insurance Act, 1938.

GIC set up in 1973 has four subsidiary companies namely, National Insurance Company Ltd., New India Assurance Company Ltd., Oriental Fire and General Insurance Company Ltd. and United Insurance Company Ltd. These companies invest their income earned through insurance premia into various types of securities and provide loan to the corporate

sector. Its investment policy is governed by the Insurance Act, 1938.

With a view to protect the interests of the policy holders and to ensure the orderly growth of insurance business, Insurance Regulatory and Development Authority has set up under Insurance Regulatory and Development Authority Act, 1999. This statutory body issues the investment regulations for both life insurance and general insurance companies.

Mutual Funds as an investment vehicle collect the savings from surplus units by means of floating unit schemes and invest the amount in the securities of industrial enterprises.

Unit Trust of India, the first Mutual Fund was set up in 1964, under Unit Trust of India Act, 1963. Presently it has 58 NAV linked schemes in operation. All these schemes including **US 64** are under compliance of SEBI. After 1987, leading public sector banks like State Bank of India, Canara Bank, PNB, LIC, GIC have set up their Mutual Funds. Since, 1993, even the private sector has also been allowed to set up their Mutual Funds. Mutual Funds are governed by SEBI regulations. Broadly two types of schemes are floated by the mutual funds: closed-end schemes and open-end schemes.

The number of Mutual Funds have increased from 7 till 1993 to 27 in 1995-96. The number of schemes floated by these funds increased to 196, mobilising the funds to the extent of Rs. 13,890 crores. Various risks are involved in investing in Mutual Funds. Important among these are: no assurance or guarantee over fulfilment of objectives of the schemes, uncertainty in the net value of units, no linkage of past performance of mutual fund with its future performance, etc.

12.7 KEY WORDS

Controlled Fund : Controlled fund means all funds pertaining to life insurance business of an insurer.

Government Guaranteed Securities : Those securities which carry the guarantee of the Government regarding payment of interest and repayment of principal.

Growth Fund : It is the fund/schemes of the Mutual Fund, which invests in equities, and

equity related instruments. Its objective is to generate capital appreciation.

Hedging : It is a method whereby one can protect himself against the loss likely to be incurred in a transaction. He undertakes another transaction for this purpose.

Index Fund : It is a growth fund. It is linked to a special index of share price. It invests in the securities of companies, which are included in the index concerned.

Market Sector : It implies investment of insurance funds in securities which are available in the capital market, besides Government and Government guaranteed securities.

Net Asset Value : It is equal to the net assets of a Unit Scheme divided by the number of outstanding units under the schemes. Net assets is the sum total of the market value of all investments plus accrued income minus the liabilities and expenses for the scheme concerned.

Sector Fund : It is also a growth fund. It invests in equity or equity related instruments of a selected sector of the economy, e.g. technology.

Social Sector : Those sectors of the economy which involve the society at large are called social sector, e.g. water supply, drainage, housing rural sector etc.

12.8 SOME USEFUL BOOKS

Bhole, L.M. (2000): *Financial Institutions and Markets,* Tata Mc Graw Hills, New Delhi

Machiraju, H.R. (1998): *Indian Financial System,* Vikas Publishing House, Delhi

Reserve Bank of India–Report on Trend and Progress of Banking in India (2000-01).

Varshney, P.N. and Mittal, D.K. (2002): *Indian Financial System,* Sultan Chand and Sons, New Delhi.

12.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) The major sectors in which Life Insurance Corporation's funds are invested are:

   i) Central Government marketable securities,

   ii) Loans of National Housing Bank,

   iii) Central Government and State Government securities, and

   iv) Socially oriented sectors.

2) The objectives for setting up IRDA are: (a) to protect the interests of the insurance policy holders, and (b) to regulate the insurance business so as to ensure its orderly growth.

3) (i) False (ii) True

Check Your Progress 2

1) a) Close-end schemes remain open for public subscription for a definite period, whereas open-end schemes remain open on continuing basis.

   b) Under Index Fund, the funds are invested in the securities of companies whose securities are included in the index concerned. Under Sector Fund, funds are invested in the equities of a selected sector.

2) i) **Asset Management Company** refers to a company which does not deal in any business activity except in the nature of management and advisory services.

   ii) The sponsor is an individual or institution that establishes a Mutual Fund.

3) i) 10% (ii) 10% (iii) At the prevailing market price

Check Your Progress 3

1) i) Securities investments are subject to market risks,

   ii) The Net Asset Value of units may go up or down, and

   iii) No guarantee or assured returns on the schemes.

2) The performance of private sector Mutual Funds has been quite impressive till 1999-2000. However, its performance has gone down in 2000-2001.

UNIT 13 CREDIT RATING AGENCIES IN INDIA

Structure

13.0 Objectives
13.1 Introduction
13.2 Meaning of Credit Rating
13.3 Determinants of Credit Rating
13.4 Rating Methodology
13.5 Credit Rating Agencies in India
13.6 Credit Rating Symbols
13.7 Benefits of Credit Rating
13.8 Rating and Default Risk
13.9 Ratings and Yields
13.10 Limitations of Credit Ratings
13.11 Let Us Sum Up
13.12 Key Words
13.13 Useful Books
13.14 Answers/Hints to Check Your Progress

13.0 OBJECTIVES

After going through this Unit, you will be able to :

- Explain the meaning and determinants of credit rating,
- Illustrate the rating methodology,
- Describe the advances and limitations of credit rating,
- Identify the credit rating symbols, and
- Discuss credit rating agencies in India.

13.1 INTRODUCTION

The removal of strict regulatory framework in recent years has led to a spurt in the number of companies borrowing directly from the capital markets. There have been several instances in the recent past where the "fly-by-night" operators have cheated unwary investors. In such a situation, it has become increasingly difficult for an ordinary investor to distinguish between 'safe and good investment opportunities' and 'unsafe and bad investments'. Investors find that a borrower's size or name are no longer a sufficient guarantee of timely payment of interest and principal. Investors perceive the need of an independent and credible agency, which judges impartially and in a professional manner, the credit quality of different companies and assist investors in making their investment decisions. Credit Rating Agencies, by providing a simple system of gradation of corporate debt instruments, assist lenders to form an opinion on the relative capacities of the borrowers to meet their

obligations. These Credit Rating Agencies, thus, assist and form an integral part of a broader programme of financial disintermediation and broadening and deepening of the debt market.

Credit rating is used extensively for evaluating debt instruments. These include long-term instruments, like bonds and debentures as well as short-term obligations, like Commercial Paper. In addition, fixed deposits, certificates of deposits, inter-corporate deposits, structured obligations including non-convertible portion of partly Convertible Debentures (PCDs) and preferences shares are also rated. The Securities and Exchange Board of India (SEBI), the regulator of Indian Capital Market, has now decided to enforce mandatory rating of all debt instruments irrespective of their maturity. Let us recall that earlier only debt issues of over 18 months maturity had to be compulsorily rated.

13.2 MEANING OF CREDIT RATING

Credit Rating Agencies rate the aforesaid debt instruments of companies. They do not rate the companies, but their individual debt securities. *Rating is an opinion regarding the timely repayment of principal and interest thereon. It is expressed by assigning symbols, which have definite meaning.*

A rating reflects default risk only, not the price risk associated with changes in the level or shape of the yield curve. It is important to emphasise that credit ratings are not recommendations to invest. They do not take into account many aspects, which influence an investment decision. They do not, for example, evaluate the reasonableness of the issue price, possibilities of earning capital gains or take into account the liquidity in the secondary market. Ratings also do not take into account the risk of prepayment by the issuer, or interest rate risk or exchange rate risks. Although these are often related to the credit risk, the rating essential is an opinion on the relative quality of the credit risk. It has to be noted that there is no privity of contract between an investor and a rating agency and the investor is not protected by the opinion of the rating agency. *Ratings are not a guarantee against loss.* They are simply opinions, based on analysis of the risk of default. They are helpful in making decisions based on particular preference of risk and return.

A company, desirous of rating its debt instrument, needs to approach a credit rating agency and pay a fee for this service. There is no compulsion on the corporate sector to obtain or publicize the credit rating except for certain instruments. A company can use the rating as another publicity exercise if it is a good one, and to obliterate it

from its prospectus and publicity, if it is not good. The Credit Rating Agencies regularly analyse the financial position of corporations and assign and revise the ratings for their securities. The different rating agencies seldom give different ratings for the same security. If two rating agencies do give the same security different ratings, it is called **split rating**; the few differences that occur are rarely more than one rating grade level apart. Accepted ratings are published in media, every week. In tune with the industrial practice in India, rating agencies do not publish ratings which are not accepted by issuers.

13.3 THE DETERMINANTS OF RATINGS

The default-risk assessment and quality rating assigned to an issue are primarily determined by three factors –

i) The issuer's ability to pay,

ii) The strength of the security owner's claim on the issue, and

iii) The economic significance of the industry and market place of the issuer.

Ratio analysis is used to analyse the present and future earning power of the issuing corporation and to get insight into the strengths and weaknesses of the firm. Bond rating agencies have suggested guidelines about what value each ratio should have within a particular quality rating. Different ratios are favoured by rating agencies. For any given set of ratios, different values are appropriate for each industry. Moreover, the values of every firm's ratios vary in a cyclical fashion through the ups and downs of the business cycle.

To assess the strength of security owner's claim, the protective provisions in the indenture (legal instrument specifying bond owners' rights), designed to ensure the safety of bondholder's investment, are considered in detail.

The factors considered in regard to the economic significance and size of issuer includes: nature of industry in which issuer is operating (specifically issues like position in the economy, life cycle of the industry, labour situation, supply factors, volatility, major vulnerabilities, etc.), and the competition faced by the issuer (market share, technological leadership, production efficiency, financial structure, etc.)

13.4 RATING METHODOLOGY

Rating is a search for long-term fundamentals and the probabilities for changes in the fundamentals. Each agency's rating process usually includes fundamental analysis of public and private issuer-specific data, industry analysis, and

presentations by the issuer's senior executives, statistical classification models, and judgement. Typically, the rating agency is privy to the issuer's short and long-range plans and budgets. The analytical framework followed for rating methodology is divided into two interdependent segments.

The first segment deals with operational characteristics and the second one with the financial characteristics. Besides, quantitative and objective factors; qualitative aspects, like assessment of management capabilities play a very important role in arriving at the rating for an instrument. The relative importance of qualitative and quantitative components of the analysis varies with the type of issuer.

Key areas considered in a rating include the following:

i) **Business Risk** : To ascertain business risk, the rating agency considers Industry's characteristics, performance and outlook, operating position (capacity, market share, distribution system, marketing network, etc.), technological aspects, business cycles, size and capital intensity.

ii) **Financial Risk** : To assess financial risk, the rating agency takes into account various aspects of its Financial Management (e.g. capital structure, liquidity position, financial flexibility and cash flow adequacy, profitability, leverage, interest coverage), projections with particular emphasis on the components of cash flow and claims thereon, accounting policies and practices with particular reference to practices of providing depreciation, income recognition, inventory valuation, off-balance sheet claims and liabilities, amortization of intangible assets, foreign currency transactions, etc.

iii) **Management Evaluation** : Management evaluation includes consideration of the background and history of the issuer, corporate strategy and philosophy, organisational structure, quality of management and management capabilities under stress, personnel policies etc.

iv) **Business Environmental Analysis** : This includes regulatory environment, operating environment, national economic outlook, areas of special significance to the company, pending litigation, tax status, possibility of default risk under a variety of scenarios.

Rating is not based on a predetermined formula, which specifies the relevant variables as well as weights attached to each one of them. Further, the emphasis on different aspects varies from agency to agency. Broadly, the rating agency assures itself that there is a good congruence between assets and liabilities of a company and downgrades the rating if the quality of assets depreciates.

The rating agency employs qualified professionals to ensure consistency and reliability. Reputation of the Credit Rating Agency creates confidence in the investor. Rating Agency earns its reputation by assessing the client's operational performance, managerial competence, management and organizational set-up and financial structure. It should be an independent company with its own identity. It should have no government interference. Rating of an instrument does not give any fiduciary status to the credit rating agency. It is desirable that the rating be done by more than one agency for the same kind of instrument. This will attract investor's confidence in the rating symbol given.

A rating is a quality label that conveniently summarizes the default risk of an issuer. The credibility of the issuer's proposed payment schedule is complemented by the credibility of the rating agency. Rating agencies perform this certification role by exploiting the economies of scale in processing information and monitoring the issuer. There is an ongoing debate about whether the rating agencies perform an information role in addition to a certification role. Whether agencies have access to superior (private) information, or if agencies are superior processors of information; security ratings provide information to investors, rather than merely summarizing existing information. Empirical research confirms the information role of rating agencies by demonstrating that news of actual and proposed rating changes affects the price of issuer's securities. Most studies document numerically larger price effects for downgrades than for upgrades, consistent with the perceived predilection of management for delaying bad news.

Check Your Progress 1

1) Discuss the meaning and significance of Credit Rating of debt instruments.

....

....

....

2) Identify the determinants of rating.

....

....

....

3) Which operational areas of the firm are taken into consideration for security rating by the rating agencies?

....

....

....

13.5 CREDIT RATING AGENCIES IN INDIA

In India, at present, there are four Credit Rating Agencies:

i) Credit Rating and Information Services of India Limited (CRISIL).

ii) Investment Information and Credit Rating Agency of India Limited (ICRA).

iii) Credit Analysis and Research Limited (CARE).

iv) Duff and Phelps Credit Rating of India (Pvt.) Ltd.

i) **CRISIL** : This was set-up by ICICI and UTI in 1988, and rates debt instruments. Nearly half of its ratings on the instruments are being used. **CRISIL's** market share is around 75%. It has launched innovative products for credit risks assessment viz., counter party ratings and bank loan ratings. **CRISIL** rates debentures, fixed deposits, commercial papers, preference shares and structured obligations. Of the total value of instruments rated, debentures accounted for 31.1%, fixed deposits for 42.3% and commercial paper 6.6%. **CRISIL** publishes **CRISIL** rating in SCAN that is a quarterly publication in Hindi and Gujarati, besides English.

CRISIL evaluation is carried out by professionally qualified persons and includes data collection, analysis and meeting with key personnel in the company to discuss strategies, plans and other issues that may effect evaluation of the company. The rating process ensures confidentiality. Once the company decides to use rating, CRISIL is obligated to monitor the rating over the life of the debt instrument.

ii) **ICRA** : **ICRA** was promoted by IFCI in 1991. During the year 1996-97, ICRA rated 261 debt instruments of manufacturing companies, finance companies and financial institutions equivalent to Rs. 12,850 crore as compared to 293 instruments covering debt volume of Rs. 75,742 crore in 1995-96. This showed a decline of 83.0% over the year in the volume of rated debt instruments. Of the total amount rated cumulatively until March-end 1997, the share in terms of number of instruments was 28.5% for debentures (including long term instruments), 49.4% for Fixed Deposit programme (including medium-term instruments), and 22.1% for Commercial Paper Programme (including short-term instruments). The corresponding figures of amount involved for these three broad rated categories was 23.8%

for debentures, 52.2% for fixed deposits, and 24.0% for Commercial Paper.

The factors that **ICRA** takes into consideration for rating depend on the nature of borrowing entity. The inherent protective factors, marketing strategies, competitive edge, competence and effectiveness of management, human resource development policies and practices, hedging of risks, trends in cash flows and potential liquidity, financial flexibility, asset quality and past record of servicing of debt as well as government policies affecting the industry are examined.

Besides determining the credit risk associated with a debt instrument, **ICRA** has also formed a group under Earnings Prospects and Risk Analysis (EPRA). Its goal is to provide authentic information on the relative quality of the equity. This requires examination of almost all parameters pertaining to the fundamentals of the company including relevant sectoral perspectives. This qualitative analysis is reinforced and completed by way of the unbiased opinion and informed perspective of one analyst and wealth of judgement of committee members. **ICRA** opinions help the issuing company to broaden the market for their equity. As the name recognition is replaced by objective opinion, the lesser know companies are also able to access the equity market.

iii) **CARE** : **CARE** is a credit rating and information services company promoted by IDBI jointly with investment institutions, banks and finance companies. The company commenced its operations in October 1993. In January 1994, CARE commenced publication of **CAREVIEW, a quarterly journal of CARE** ratings. In addition to the rationale of all accepted ratings, CAREVIEW often carries special features of interest to issuers of debt instruments, investors and other market players.

13.6 CREDIT RATING SYMBOLS

Credit Rating Agencies rate an instrument by assigning a definite symbol. Each symbol has a definite meaning. These symbols have been explained in descending order of safety or in ascending order of risk of non-payment. For example, **CRISIL** has prescribed the following symbols for debenture issues:

AAA indicates highest safety of timely payment of interest and principal.

AA indicates high safety of timely payment of interest and principal.

A indicates adequate safety of timely payment of interest and principal.

BBB offers sufficient safety of payment of interest and principal for the present.

BB offers inadequate safety of timely payment of interest and principal.

B indicates great susceptibility to default.

C indicates vulnerability to default. Timely payment of interest and payment is possible nly if favourable circumstances continue.

D indicates that the debenture is in default in payment of arrears of interest or principal or is expected to default on maturity.

You will note that as the value of symbol is reduced say from AAA to AA, the safety of timely payment of interest and principal is decreased. While AAA indicates highest safety of timely repayment, D indicates actual default or expected default on maturity. Different symbols indicate different degrees of risk of repayment of principal and interest. It is the assessment of the Rating Agency based on the methodology already explained. Other ratings are given in the Appendix to this Unit for your information.

13.7 BENEFITS OF CREDIT RATING

Rating serves as a useful tool for different constituents of the capital market. For different classes of persons, different benefits accrue from the use of rated instruments.

1) **Investors** : Rating safeguards against bankruptcy through recognition of risk. It gives an idea of the risk involved in the investment. It gives a clue to the credibility of the issuer company. Rating symbols give information on the quality of instrument in a simpler way that can be understood by lay investor and help him in taking decision on investment without the help from broker. Both individuals and institutions can draw up their credit risk policies and assess the adequacy or otherwise of the risk premium offered by the market on the basis of credit ratings.

2) **Issuers of Debt Instruments** : A company whose instruments are highly rated has the opportunity to have a wider access to capital, at lower cost of borrowing. Rating also facilitates the best pricing and timing of issues and provides financing flexibility. Companies with rated instruments can use the rating as a marketing tool to create a better image in dealing with its customers, lenders and creditors. Ratings encourage the companies to come out with more disclosures

about their accounting systems, financial reporting and management pattern. It also makes it possible for some category of investors who require mandated rating from reputed rating agencies to make investments.

3) **Financial Intermediaries** : Financial intermediaries like banks, merchant bankers and investment advisers find rating as a very useful input in the decisions relating to lending and investments. For instance, with high credit rating, the brokers can convince their clients to select a particular investment proposal more easily thereby saving on time, cost and manpower in convincing their clients.

4) **Business Counter-parties** : The credit rating helps business counter-parties in establishing business relationships particularly for opening letters of credit, awarding contracts, entering into collaboration agreements, etc.

5) **Regulators** : Regulators can, with the help of credit ratings, determine eligibility criteria and entry barriers for new securities, monitor financial soundness of organizations and promote efficiency in debt securities market. This increases transparency of the financial system leading to a healthy development of the market.

13.8 RATING AND DEFAULT RISK

Most investors prefer to use credit ratings to assess default risk. Internationally acclaimed credit rating agencies such as Moody's, Standard and Poor's and Duff and Phelps have been offering rating services to bond issuers over a very long time. The bond issuers pay the rating agency to evaluate the quality of the bond issue in order to increase the information flow to investors and hopefully increase the demand for their bonds. The rating agency determines the appropriate bond rating by assessing various factors. For example, Standard and Poor's judges the credit quality of corporate bonds largely by looking at the bond indenture, asset protection, financial resources, future earning power, and management. More specifically, Standard and Poor's focuses on cash flows to judge a firm's financial viability. The bond categories are assigned letter grades. The highest-grade bonds, whose risk of default is felt to be negligible, are rated triple A (Aaa or AAA). The rating agencies assign pluses or minuses (e.g. Aa + A+) when appropriate to show the relative standing within the major rating categories. The following table gives the rating symbols and their explanation as employed by Moody's and S & P, the well-known rating agencies.

Table 13.1 : Rating Category of Credit Agency Firms

Moody's	Explaination
Aaa	Best quality
Aa	High quality
A	Higher-medium grade
Baa	Medium grade
Ba	Possess speculative elements
B	Generally lack characteristics of desirable investment
Caa	Poor standing; may be in default
Ca	Speculative in a high degree; often in default
C	Lowest grade

Standard & Poor's	Explaination
AAA	Highest grade
AA	High grade
A	Upper medium grade
BBB	Medium grade
BB	Lower medium grade
B	Speculative
CCC-CC	Outright speculation
C	Reserved for income bonds
DDD-DD	In default, with rating indicating relative salvage value

Not all bonds are rated by the agencies. Small issues and those placed privately are generally not rated. For those bonds that are rated, the competing services generally rank the same bond in the same rating category; seldom do they disagree by more than one grade. The research has shown that there is a high degree of correlation between bond-quality ratings and actual defaults. Large number of firms with low rationgs usually default. This suggests that knowledge about credit rating does help in assessing the financial risks that can lead to default.

13.9 RATINGS AND YIELDS

The ratings assigned to a bond issue directly affects its

yield. Issuers of high-risk securities have to pay higher rates of return than issuers of low risk securities. Junk bonds, for instance, are a high risk and a high yield instrument. Investment may be limited in such instruments. A study of the average yields to maturity for different categories of bonds (bond index) over various time periods (1955-67, 1968-79 and 1981-85) reveals that market yields increase with increased risk. Investors dislike risk. Risk avoidance is visible not only in the long-run but also in short-run. Bonds rated poorly must pay higher yield in the market place to attract risk-averse investors. The higher the rating, the lower is the bond's yield. The difference in yield is termed as the yield spread. The yield spread between two rating categories provides a measure of the default risk premium. While yield spreads related to default risk are not constant over time, they do remain in the appropriate relative pattern. That is, AAA rated bonds always sell at lower yields than Aa bond, which in turn sell at lower yields than A-rated bonds, and so forth. Investors often use the highest rating category as a benchmark yield and compute yield spreads for lower-rated bonds.

In India, one can say, the relationship between ratings and cost of funds is, at best, tenuous. It has been observed that many times similar rated companies are accessing funds at widely disparate rates of interest. This signifies that the market perception of the investment risk of such companies is different even though credit rating agency has placed them in the same category (symbol). One can conclude that as ratings fail to capture the market's perception of risk, there is indeed something wrong with ratings assigned to these companies.

A number of research studies suggest that the determinants of credit rating and yield spread for corporate bonds include:

i) debt ratios,

ii) earnings-levels,

iii) earnings-variability,

iv) interest coverage, and

v) pension obligations.

Since about 75% of yield spread and ratings variability are explained with these variables, other subjective factors may play an important role. The yield-spread pattern also changes in magnitude over the business cycle; yield spreads widen (narrows) during recessions (prosperous periods). A reasonable explanation of expanding and contracting yield spreads is that during recession, default risk rises more than proportionally for lower-quality firms because of reduced cash flows. Also, investors may become risk-averse as their wealth decreases during recessions.

13.10 LIMITATIONS OF CREDIT RATINGS

There are several limitations of credit ratings. *First,* credit ratings are changed when the agencies feel that sufficient changes have occurred. The rating agencies are physically unable to constantly monitor all the firms in the market. The opinions of rating agencies may turn wrong in the context of subsequent events that may have an adverse impact on asset quality of the issuer.

Second, the use of credit ratings imposes discrete categories on default risk, while, in reality default risk is a continuous phenomenon. Moody's recognised this way back in 1982 by adding numbers to the letter system, thereby increasing its number of rating categories from 9 to 19. Nevertheless, this limitation still pertains. The letter grades assigned by rating agencies serve only as a general, somewhat coarse form of discrimination.

Third, owing to time and cost constraints, credit ratings are unable to capture all characteristics for an issuer and issue.

A borrowing company can reduce the cost of borrowing, if it obtains a higher rating for its contemplated issue. The stakes and pressures, consequently, to get a good quality rating are high. If the company comes to know that its issue is going to get a low quality rating, it may approach another agency and then use the best rating among them since it is not under obligation to disclose all ratings. According to the practice in the rating industry in India, a corporate entity has the option of not agreeing to the first rating given to its debt issue and can choose not to get rated by that agency at all. In such a situation, the rating agency cannot divulge its assessment to anybody, and the corporate entity is free to go to any other agency. But once the corporate entity agrees with the first rating, it has no option of getting out of the rating discipline imposed by the rating agency. This may tempt rating agencies to woo clients with the help of an initial favourable rating, but the freedom may eventually be misused by the rating agency because corporate client doesn't have the option to differ with the agency, once it initially agrees to get rated by it. To ensure that corporate clients are not dependent on one rating agency, the system of compulsory dual ratings of all instruments could be considered. Sometimes, the rating agency may reduce the rigor of their criteria on their own to enlarge the business and improve profits especially if they are a listed company. Investors should, therefore, not follow blindly the ratings of different agencies in regard to the safety of fixed income instruments. The investors should explore other alternative evaluation sources so that they become aware of the true risks involved. The rating agencies have to be alert to ensure that their rating decisions are not driven by volume

and profitability with a view to ensure favourable impact on the price of its share. It may be asserted that the rating agencies should be judged by overall performance and not by one or two defaults. There are instances of default in the instruments rated as investment grade of high safety by top agencies of the world.

Once the corporate agrees with the first rating, the rating agency is obliged to assess the debt issue till its maturity and publish the rating as part of its surveillance system. It has been observed that rating agencies have miserably failed in predicting the brewing crisis and have continued to give investment grade rating to companies, which have eventually defaulted. It has been argued that CRB scam would not have taken place if we had a better credit rating agency that would have cautioned in time on the status of the company. After the crisis, rating agencies became overcautious and resorted to drastic downgrades of ratings in respect of specific companies.

For instance, CRISIL, ICRA, and CARE downgraded respectively 140, 35 and 50 companies in 1997. Of the rating changes effected by CRISIL, ICRA, and CARE–36%, 40% and 64% respectively were by three or more notches.

Table 13.2 : Downgrades of Ratings (in percentage) in 1997

	CRISIL	ICRA	CARE
By one notch	35.0	28.6	22.0
By two notches	29.3	31.4	14.0
By three notches	12.9	8.6	20.0
By four notches	7.9	8.6	4.0
By more than four notches	15.0	22.9	40.0
Total downgrades	**140**	**35**	**50**

The high proportion of companies whose investment grade rating was overnight changed to non-investment grade is not conducive for enhancing the faith of investors in ratings.

In India, as in the developed countries, rating changes often lag the variations in stock prices. Of the 157 rating downgrades made by the three rating agencies in 1997, in 130 companies, the change in ratings lagged the decline in share prices. Despite evidence that stock price movements do eventually lead to a change in ratings, there is reason to believe that further changes are urgently needed when the ratings of companies and their stock prices are compared. This need is more prominent in the case of the investment grade ratings granted to NBFCs by CRISIL and ICRA than to the companies which are trading below par, yet command investment grade rating.

Check Your Progress 2

1) Distinguish between AAA, AA and A ratings given by CRISIL

....

....

....

2) State whether following are advantage or limitation of credit rating:

   i) Credit Ratings are unable to capture all characteristics of an issuer or issue.

   ....

   ii) Rating provides best financing flexibility.

   ....

   iii) Rating agencies are unable to monitor all types of firms in the market.

   ....

3) State the following sentences are true or false:

   i) The issuers of high-risk securities pay lower rate of return. (T/F)

   ii) Higher the rating of a security, higher the chances of its default. (T/F)

   iii) All types of bonds including small issues are rated by credit rating agencies. (T/F)

13.11 LET US SUM UP

The term Credit Rating refers to evaluation of debt instruments. Debt instruments include both long-term instruments like bonds and debentures, and short-term obligations like Commercial Paper. Apart from these, fixed deposits, certificates of deposits, inter-corporate deposits, structured obligations, etc. are also rated. Now Securities and Exchange Board of India (SEBI) has decided to enforce mandatory rating of all debt instruments irrespective of their maturity. Rating serves as a useful tool for different constituents of the capital market namely investors, issuers of debt instruments, financial intermediaries, business enterprises, regulators, etc. High degree of correlation has been observed between bond quality ratings and actual defaults. The ratings assigned to bond issue directly affects its yield. Issuers of high-risk securities have to pay higher rates of return than issuers of low risk securities. A number of difficulties arise in the quality rating assigned to an issue. Primarily the issuer's ability to pay, the strength of the security owner's claim, the economic significance and

size of the issuer are taken into consideration in determination of rating. The ratings assigned by the credit rating agencies have many limitations. Important among these are : (i) credit rating change infrequently. (ii)Any rating reflects default risk and not the price risk associated with changes in the level or shape of the yield curve, etc. However, the reputation of an agency creates a confidence in investor.

In India, at present, there are four credit rating agencies of which the following three are well-known :

i) Credit Rating and Information Services of India (CRISIL)

ii) Investment Information and Credit Rating Agency of India Ltd. (ICRA)

iii) Credit Analyses and Research Limited (CARE)

13.12 KEY WORDS

Business Risk : Risk which is inherent in the nature of business of a company.

Credit Risk : Risk associated with a debt instrument due to the non-payment by the issuer of the instrument.

Convertible Debentures : The debentures which are convertible into equity shares of a company, either wholly or partially, at the option of the debenture-holders, are called convertible debentures.

Financial Risk : Risk which is associated with the pattern of financing a business, e.g. greater proportion of debt.

Fly by Night Operators : The promoters of those companies which want to get rich quickly by any means are called fly by night operators.

Inter-corporate Deposits : Deposits of money made by one company in another company.

Letter of Credit : It is a letter issued by the banker of the buyer in favour of the seller giving an undertaking that the seller's claims against the buyer will be met by the banker, if the former fails to do so.

Ratio Analysis : It means interpretation of the balance

sheet and profit and loss account of a company by computing ratios between different figures contained therein.

Split Rating : When two rating agencies give the same security different ratings, it is called split rating.

13.13 SOME USEFUL BOOKS

Clark, J. (1976): "Some Recent Trends in Municipal and Corporate Securities Markets: An Interview with Brenton W. Harries, President of Standard and Poor's Corporation," *Financial Management.*

Francis, J.C. (1993): *Management of Investments,* 3rd Edition, McGraw Hills, New Delhi

Jaffee, D. (1975), "Cyclical Variations in the Risk Structure of Internet Rates", *Journal of Monetary Economics* (July, 1975).

Krishnamurthy, Suresh (1998), "Rating Agencies", Shooting Themselves in the Foot" *Business Line,* June 28, 1998.

Reserve Bank of India, Report on Currency & Finance 1996-97, Mumbai.

Sherwood, H (1976) How Corporate and Municipal Debt is Rated : An Inside Look at Standard and Poor's Rating System, Wiley, New York.

M.Y. Khan (2000): *Financial Services,* Vikas Publishing House, New Delhi.

13.13 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Credit Rating refers to evaluation of debt instruments by assigning a quality rating to an issue. Ratings are simply opinions based on analysis of the risk of default. Credit ratings are helpful in making decisions based on particular preference of risk and return.

2) The determinants are: (i) the issuer's ability to pay the strength of the security owner's claim on the issue, and (ii) the economic significance of the industry and market place of the issuer.

3) Industry's capacity, its market share, distribution system and marketing network.

Check Your Progress 2

1) AAA rating reflects the highest safety of timely payment of interest and principal amount. AA indicates high safety, whereas A indicates adequate safety of timely payment of interest and principal.

2) (i) Limitation (ii) Advantage (iii) Limitation

3) (i) False (ii) False (iii) False

Annexure

Rating symbols and their explaination

Rating Symbols used by CARE:

Symbols	**(A) Long-term and Medium-term Instruments (Fixed Deposits, Certificates of Deposits, Structured Obligation, Cumulative Convertible Preference Shares)**
AAA	Debt Instruments carrying the rating are considered to be of the best quality, carrying negligible investment risk. Debt service payments are protected by stabled cash flows with good margin. While the under-lying assumptions may change, such changes as can be visualised are most unlikely to impair the strong position of such instruments.
AA	Instruments carrying this rating are judged to be of high quality by all standards. They are also classified as high investment grade. They are rated lower than AAA.
A	Instruments with this rating are considered upper medium grade instruments and have many favourable investment attributes. Safety for principal and interest are considered adequate. Assumptions that do not materialise may have a greater impact as compared to the instruments rated higher.
BBB	Such instruments are considered to be of investment Grade. They indicate sufficient safety for payment of interest and principal, at the time of rating. However, adverse changes in assumptions are more likely to weaken the debt servicing capability compared to the higher rated instruments.
BB	Such instruments are considered to be speculative, with inadequate protection for interest and principal payments.
B	Instruments with such rating are generally classified susceptible to default. While interest and principal payments are being met, adverse changes in business conditions are likely to lead to default.
C	Such instruments carry high investment risk with likelihood of default in the payment of interest and principal.
D	Such instruments are of the lowest category. They are either in default or are likely to be in default soon.

Symbols	(B) Short-term Instruments
PR-1	Instruments would have *superior capacity* for repayment of short-term promissory obligations. Issuers of such instruments will normally be characterised by leading market positions in established industries, high rates of return on funds employed, etc.
PR-2	Instruments would have *strong capacity* for repayment of short-term promissory obligations. Issuers would have most of the characteristics as for those with PR-1 instruments but to a lesser degree.
PR-3	Instruments have an *adequate capacity* for repayment of short-term promissory obligations. The effect of industry characteristics and market composition may be more pronounced. Variability in earnings and profitability may result in changes in the level of debt protection.
PR-4	Instruments have minimal degree of safety regarding timely payment of short-term promissory obligations and the safety is likely to be adversally affected by short term adversity or less favourable conditions
PR-5	The instrument is *in default* or is likely to be in default on maturity.

Symbols	(C) Credit Analysis Rating
CARE-1	*Excellent* debt management capability. Such companies will normally be characterised as leaders in the respective industries.
CARE-2	*Very good* debt management capability. Such companies would normally be regarded as close to those rated CARE-1, but with a lower capability towithstand changes in assumptions.
CARE-3	*Good capability* for debt management. Such companies are considered medium grade. Assumptions that do not materialise may impair debt management capability in future.
CARE-4	*Barely satisfactory capability* for debt management. The capacity to meet obligations is likely to be adversely affected by short -term adversity or less favourable conditions.
CARE-5	*Poor capability* for debt management. Such companies are in default or are likely to default in meeting their debt obligations.

Notes :

1) *CCPS* : Cumulative Convertible Preference Shares; *FD* : Fixed Deposits; *CD* : Certificates of Deposit; *SO* : Structured Obligations; *CP* : Commercial Paper; *ICD* : Inter-Corporate Deposits.
2) As instrument characteristics or debt management capability could cover a wide range of possible attributes whereas rating is expressed in limited number of symbols, CARE assigns '±' or '-' signs to be shown after the assigned rating (wherever necessary) to indicate the relative position within the band covered by the rating symbol.

Symbols	CRISIL Fixed Deposit Rating Symbols
FAAA (F-Triple-A) Highest Safety	This rating indicates that the degree of safety regarding timely payment of interest and principal is very strong.
FAA (F-Double-A) High Safety	This rating indicates that the degree of safety regarding timely payment of interest and principal is strong.
FA Adequate Safety	This rating indicates that the degree of safety regarding timely payment of interest and principal is satisfactory.
FB Inadequate Safety	This rating indicates inadequate safety of timely payment of interest and principal.
FC (High Risk)	This rating indicates that the degree of safety regarding timely payment of interest and principal is doubtful.
FD (Default)	This rating indicates that the issuer is either in default or is expected to be in default upon maturity.

Symbols	(C) CRISIL Rating for Short-term Instruments
P1 (Highest Safety)	This rating indicates that the degree of safety regarding timely payment of interest and principal on the instrument is very strong.
P2 (High Safety)	This rating indicates that the degree of safety regarding timely payment of interest and principal on the instrument is very strong.
P3 (Adequate Safety)	This rating indicates that the degree of safety regarding timely payment of interest and principal on the instrument is satisfactory.
P4 (Inadequate Safety)	This rating indicates that the degree of safety regarding timely payment on the instrument is minimal.
P5 (Default)	This rating indicates that the issuer is either in default or is expected to be in default upon maturity.

ICRA'S Rating Symbols

Symbol	**(A) Long-term Debt-Debentures, Bonds and Preference Shares** (The letter 'P' is added to indicate that debt instrument is being issued to raise resources for a new entity for financing a new project and the rating assumes successful completion of the project).
LAAA (Highest Safety)	Indicates fundamentally strong position. Risk factors are negligible. There may be circumstances adversely affecting the degree of safety but such circumstances, as may be visualised, are not likely to affect the timely payment of principal and interest as per terms.
LAA (High Safety)	Risk factors are modest and may vary slightly. The protective factors are strong and prospects of timely payment of interest and principal as per terms, under adverse circumstances, as may be visual-ised, differ from LAAA only marginally.
LA+, LA, LA- (Adequate Safety)	Risk factors are more variable and greater in periods of economic stress. The protective factors are average and any adverse change in circumstances, as may be visualised, may alter the fundamental strength and affect the timely payment of principal and interest as per terms.
LBBB+, LBBB, LBBB-(Moderate Safety)	Considerable variability in risk factors. The protective factors are below average. Adverse changes in business/economic circumstances are likely to affect the timely payment of principal and interest as per terms.
LB+, LB, LB-, (Risk Prone)	Risk factors indicate that obligations may not be honoured when due. The protective factors are narrow. Adverse changes in business/economic conditions could result in inability unwillingness to service debt on time as per terms.
LC+, LC, LC- (Substantial Risk)	There are inherent elements of risk and timely servicing of debt/obligations could be possible only in case of continued existence of favourable circumstances.
LD (Default)	Extremely speculative. Either already in default of payment of interest and/or principal as per terms or expected to default. Recovery is only likely on liquidation or reorganisation.

Symbol	(B) Medium-term debt including Fixed Deposit Programmes
MAAA (Highest Safety)	The prospect of timely servicing of the interest and principal as per terms is the best.
MAA+, MAA, MAA- (High Safety)	The prospect of timely servicing of the interest and principal as per terms is high, but not high as in MAAA rating.
MA+, MA, MA-, (Adequate Safety)	The prospect of timely servicing of the interest and principal is adequate. However, debt servicing may be affected by adverse changes in the business/economic conditions.
MB+, MB, MB-(Inadequate Safety)	The timely payment of interest and principal are more likely to be affected by future uncertainties.
MC+, MC, MC-, (Risk Prone)	Susceptibility to default high. Adverse changes in business/economic conditions could result in inability/unwillingness to service debts on time and as per terms.
MD (Default)	Either in default or expected to default.
A1+, A1, (Highest Safety)	The prospect of timely payment of debt/obligation is the best.
A2+, A2 (High Safety)	The relative safety is marginally lower than in A1 rating.
A3+, A3, (Adequate Safety)	The prospect of timely payment of interest and instalment is adequate but any adverse change in business/economic conditions may affect the fundamental strength.
A4+, A4, (Risk Prone)	The degree of safety is low. Likely to default in case of adverse changes in business/economic conditions.
A5 (Default)	Either in default or expected to default.

UNIT 14 INDIA AND THE GLOBAL FINANCIAL SYSTEM

Structure

14.0 Objectives
14.1 Introduction
14.2 International Financial Institutions
  14.2.1 International Monetary Fund (IMF)
  14.2.2 International Bank on Reconstruction and Development (IBRD)
  14.2.3 International Finance Corporation (IFC)
  14.2.4 International Development Association (IDA)
  14.2.5 Asian Development Bank (ADB)
14.3 European Monetary System
14.4 Euromarket
14.5 India and Foreign Currency Finance
  14.5.1 External Commercial Borrowings
  14.5.2 Euro Issues-GDRs
  14.5.3 Foreign Direct Investments
  14.5.4 Portfolio Investments
  14.5.5 Non-Resident Indians' Deposits
14.6 Let Us Sum Up
14.7 Key Words
14.8 Some Useful Books
14.9 Answers/Hints to Check Your Progress

14.0 OBJECTIVES

After going through this Unit, you will be able to:

- Summarise the functioning of International Financial Institutions like IMF, IBRD, IFC and IDA etc, in terms of their objectives, organisational structure, functions and financing schemes being run,
- Explain the Euro Market and its segments,
- State the sources of raising long/medium-term foreign currency finance for Indian companies, and
- Describe the European Monetary System.

14.1 INTRODUCTION

In this age of globalisation, no country could remain in isolation. So, is the case with the financial system of a country. In developing countries like India, there is a greater need for foreign investment depending on foreign sources of finance. We have different sources to obtain the same. There are international financial institutions, which lend for specific purposes in deserving cases. Besides, there are various other avenues of taping foreign currency resources by Indian corporates both in the form of equity and debt obligations.

During recent years there had been growing inflow of funds through these channels into India. In this Unit, we shall study about these sources of external finance available to India.

14.2 INTERNATIONAL FINANCIAL INSTITUTIONS

14.2.1 International Monetary Fund

The International Monetary Fund (IMF) came into existence at the Bretton Woods conference held in July 1944 with 44 countries as its members. Currently, most of the countries, with the exception of Cuba, are its members. IMF is the central institution of the international monetary system. The major objective of IMF is to help its member countries in correcting the balance of payment imbalances. This improvement is brought about through changes in macro-economic policies. Keeping this in view, IMF conducts studies and recommends changes in the areas of monetary, tariff and exchange rate policies. IMF, in recent times, has taken active role in longer-term efforts to solve the third-world debt problem.

Objectives : The objectives of the IMF, as set out in its Articles of Agreement, are as follows :

i) To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

ii) To facilitate the expansion and balanced growth of international trade and thereby to contribute the promotion and maintenance of high levels of employment and real incomes and to the development of the productive resources of all members as primary objectives of economic policy.

iii) To promote exchange stability so as to maintain orderly exchange arrangements among members, and avoid competitive exchange depreciation.

iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

v) To generate confidence among its members by making the general resources of the Fund temporarily available to them. This provides them the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive to national or international prosperity.

vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the balance of payments of its member countries .

Thus, in addition to monitor the proper conduct of the international monetary system, IMF also provides assistance to countries facing temporary balance of payments crisis.

Organisational Structure : The IMF is an autonomous organization with 181 countries as its members. The highest policy-making body is the Board of Governors in which each member-country is represented by a Governor and an alternate Governor. The administrative responsibilities are vested in the Board of Executive Directors.

Exchange Rates : As stated above one of the objectives of IMF is to promote exchange stability. To achieve this, initially each member country was required to establish the par value of its currency in terms of gold or US dollars and to undertake to maintain the same within 1% of the declared par value. The par value was permitted to be changed with the prior approval of the IMF. Such a change was permitted if the member country was suffering from a fundamental disequilibrium in its balance of payments. The system came to be known as 'adjustable peg system' as it provided for the adjustment of exchange rates.

The above arrangement continued till early seventies of the previous century. After a series of devaluation of the US dollars, the system called the Bretton Woods System, finally collapsed in Mach 1973, when 14 major nations decided to float their currencies. Currently, about 1/3rd of the IMF member countries have floated their currencies—some have fixed parity of their currency with US dollars, some have fixed with French Francs, while others have fixed with SDRs.

Resources : The main resource of the IMF is the subscription made by the member-countries to its capital. Contribution by each member country is called the Quota, which is based on various factors such as country's national income, reserves, exports variability and ratio of exports to national income. Initially, member countries were required to subscribe to the quota in the form of gold or US dollars to the extent of 25% and the balance, in the form of country's own currency. Presently, however, the contribution in gold may be made in the form of Special Drawing Rights (SDRs) or other foreign currencies. Quotas are reviewed at intervals of not more than five years. In 1994, the capital of the IMF was SDR 144.6 billion.

Besides the subscriptions against the quotas received from the member countries, the IMF also has the power to borrow under the "General Arrangement to Borrow". Under this arrangement, the ten industrialised countries agreed to lend

to the IMF their own currencies up to a limit agreed upon. Originally, IMF could borrow these funds, under this arrangement, only when the participant countries need the funds. However, now the IMF can also have access to these funds to finance drawings by other countries, provided the borrowing countries agree to economic adjustment programme approved by the IMF.

Special Drawing Rights (SDRs)

The monetary system propounded at the BrettonWoods played a positive role in the rapid expansion of the world trade. However, one of its major shortcomings was that there was no provision for expanding the supply of international reserves necessary to support expanding trade. This eventually led to increase in holdings of national currencies, and in particular it strengthened the position of US dollars as the international reserve currency. The US dollars became the reserve asset of the new monetary system. But with the world trade growing, the need for international liquidity grew. To meet this need for international currency, continuing deficit in US balance of payment, it was essential to put dollars into the system. This shortage of international liquidity reached its height in late 1960s. The IMF countered this problem by the creation of a new international reserve asset called the **'Special Drawing Rights (SDRs)'**, in 1969.

Originally, the SDR was equivalent to a fixed number of dollars. Now, it is a basket of various currencies such as US dollars, German Deutschmarks, Japanese Yen, French Francs and British Pound Sterling. These SDRs were allocated to the member countries in 1969 just as bonus shares are issued to the shareholders of a company.

Financing Schemes : One of the objectives of the IMF is to provide financial support to member countries, which are facing balance of payment deficits. The most important window of financing is the Drawing from the IMF. Under this scheme, whenever a member country requires foreign currency to tide over its short-term deficits in the balance of payments position, it tenders its own currency to the IMF and gets the required foreign exchange. This is called as "drawings" from the IMF. Once the balance of payments position of the borrower country improves, it "repurchases" its currency and pays back the foreign currency. Ordinarily, a member can draw not more than 25% of its quota during 12 months period. The aggregate drawing by a member can go up to a level where the IMF's holding of the concerned member country's currency reaches 200% of the quota. For example, if country "A" has a quota of SDR 100, of which 75% has to be contributed in its own currency i.e. country A contributed equivalent of SDR 75 in its own currency. Country A can borrow up to a maximum of SDR 125 so that the total holding of the country A's currency would reach

SDR 200 which is 200% of the country's quota. This condition can, however, be waived in special circumstances.

The process of a member country to draw from the IMF is divided into stages or "Tranches". The borrowing which takes the IMF's holding of the borrowers' own currency to 100% of the country's quota is called the "Reserve Tranche". Any borrowing beyond the reserve tranche is divided into four equal tranches called the "Credit Tranches". A country can freely draw upon the reserve tranche but drawings from the credit tranches are subject to scrutiny by the IMF.

The IMF also has other schemes of financial assistance. Some of the schemes are as follows :

i) **Standby Arrangements** : Under this arrangement, a member is allowed to draw upon the resources of the IMF up to a specific limit and within a specific time frame. Such facility is to be negotiated between the IMF and the member country. It is similar to the overdraft facility offered by commercial bank.

ii) **Structural Adjustment Facility** : This scheme is aimed at providing financial assistance to member countries facing prolonged balance of payment problems and as remedial measures follow the medium term macro economic structural adjustment programme (SAP). SAP in such countries aims at fostering growth and strength-ening the balance of payments position. Loans privided under SAP are in proportion to the member country's quota. These loans are normally disbursed over a period of three years during which the borrower country has to draw up three-year comprehensive strategy for ensuring structural adjustment.

iii) **Enhanced Structural Adjustment Facility** : This scheme is similar to the Structural Adjustment Facility but is meant specifically for the poorest member-countries when they are undertaking a strong three year macro-economic and structural programme.

iv) **Extended Fund Facility** : The Extended Fund Facility has been formulated to assist the member countries in meeting their balance of payment deficits for longer periods and in larger amounts than available under the normal drawings programme. This facility is for countries suffering from serious balance of payments problems due to structural maladjustment in production, trade and prices.

14.2.2 International Bank for Reconstruction and Development (IBRD)

International Bank for Reconstruction and Development (IBRD) more popularly known, as World Bank, is also the

creation of the Brettonwoods Conference held in 1944. The main function of the World Bank is to provide long-tem financial assistance to its member countries for their reconstruction and development. Initially, the World Bank concentrated its efforts on the war-ravaged economies of Europe but later shifted its focus to the development of backward countries.

Functions : The main functions of the World Bank are:

i) To assist in reconstruction and development of its member-countries by facilitating investment of capital for productive purposes.

ii) To promote foreign private investment by guaranteeing of or through participation in loans and other investments of capital for productive purposes.

iii) To make loans for productive purposes out of its own resources or out of the funds borrowed by it where private capital is not available on reasonable terms.

iv) To promote the long-term growth of international trade and the maintenance of equilibrium in the balance of payments of members by encouraging international investment for the development of the productive resources of members.

Thus, the World Bank provides funds for productive projects, which lead to economic development in its member countries.

Organisational Structure : The management of the World Bank consists of a Board of Governors, Executive Directors and a President. Of the 22 Executive Directors, 5 are nominated by the 5 biggest shareholders–USA, UK, Germany, Japan and France. The President acts as the Chairman of the Board of Executive Directors. The voting rights of the Governors and the Executive Directors are proportionate to the share-capital of the member country they represent. Hence, the policies of the World Bank tend to be influenced by the large shareholder countries.

Resources : The resources of the World Bank consist of the capital contributions from its member countries besides the borrowings from the international capital markets. Initially, the capital of the World Bank was $ 10,000 million, which was contributed in Gold or US dollars (2%); member's own currency (18%) and the balance 80% was kept as reserve, to be contributed whenever called upon. Thus, only 20% of each member-country's contribution to the capital was available to the Bank for lending purposes, while the balance 80% served as guarantee resource to back the Bank's borrowings in the international markets. The capital has been enhanced periodically and at present stands at $ 170 billion.

Financial Schemes : The World Bank provides financial assistance mostly in the form of direct loans or guarantees. The assistance is provided for productive purposes such as agriculture and rural development, power, industry and transport projects. The World Bank grants loans having a repayment period of 10 to 35 years. These loans are made to the Governments of member countries or are guaranteed by the Government concerned. The rate of interest charged by the Bank is the estimated cost to the Bank, of borrowed money of comparable maturity period from the market. Besides this, the Bank charges commission @ 1% for the purpose of creating a special reserve against loss and 0.5% for covering the administrative expenses.

Besides the lending activities, the Bank also provides technical assistance in undertaking a full-scale economic survey of the developmental potential of member country and provides technical advice on the assisted projects. India has been the single largest borrower of finance from the World Bank.

14.2.3 International Finance Corporation (IFC)

The International Finance Corporation (IFC) is an affiliate of the World Bank. Only the members of the World Bank can become its members. As the World Bank can provide only loan funds and is not allowed to participate in the equity of a project, IFC was established in 1956 with the mandate to provide equity funds also to the private enterprises.

Functions : IFC encourages development of the private sector in the member-countries. Its main functions are :

i) to invest in the private sector of the member countries, in association with private investors and without Government guarantee, in case where sufficient private capital is not available on reasonable terms;

ii) to provide investment opportunities—both foreign and domestic, and experienced management, and

iii) to stimulate conditions conducive to the flow of private capital—both foreign and domestic, into productive investments in member countries.

Organisational Structure : Being an affiliate of the World Bank, the Board of Governors of the World Bank is also the Board of Governors of the IFC. Further, the Executive Directors of the World Bank constitute the Board of Directors of IFC, which is responsible for the operations of IFC. The day-to-day operations are conducted under the superintendence of the Executive Vice-President.

Resources : The resources of the IFC consists of the capital

contributed by the members and the accumulated reserves. It can also borrow resources from the World Bank upto four times of its net worth.

Financing Schemes : IFC provides long-term loans or invests in the equity capital of a wide variety of productive private enterprises in the developing countries. The project assisted should be economically viable and beneficial to the economy of the member country. The minimum quantum of financial assistance provided by IFC is US $ 1 million and the maximum is US $ 100 million. Further, IFC's assistance usually does not exceed 50% of the total investment in a project.

Besides direct lending and equity investment, IFC also provides developmental services such as: identification and promotion of projects, promotion and establishment of privately owned developmental finance companies, encouragement of the growth of capital markets and advisory/ technical counsel on measures that will create a climate conducive for the growth of private sector.

14.2.4 International Development Association (IDA)

International Development Association (IDA) is another affiliate of the World Bank and is also referred to as the "soft loan window" of the World Bank. It provides "soft loans" for economically sound projects of social importance to the member countries. The projects funded by IDA typically include projects like construction of roads, bridges, slum dwellings, etc. Such projects fall under the category of "high development priority" due to the impact of their benefit on the development of the area concerned, but the returns from the projects are not sufficient to pay the high rates of interest on borrowings. The IDA provides loans for such projects free of interest. These loans have longer maturity periods.

Functions and Financial Assistance : IDA extends financial assistance to high priority projects in the member countries. The finance may be made available to the member Governments or to the private enterprises. Advances to private enterprises may be made without government guarantees. IDA also co-operates with other international institutions and member countries in providing financial and technical assistance to the less developed countries. Salient features of the financial assistance provided by IDA are as follows :

i) The financial assistance provided by IDA is interest free. IDA charges a small service charge @ 0.75% p.a. on the amount withdrawn, so as to cover the administrative expenses,

ii) Repayment period is usually over 50 years with an initial moratorium of 10 years,

iii) IDA finances not only the foreign exchange component but also the domestic cost, and

iv) The assistance can also be repaid in the local currency of the borrowing country.

Organisational Structure

All member countries of the World Bank are eligible to become the member of the IDA. As in the case of IFC, the Board of Governors and Executive Directors of the World Bank are also the Board of Governors and Executive Directors of the IDA.

14.2.5 Asian Development Bank (ADB)

Asian Development Bank (ADB) was started in 1966 under the aegis of the United Nations Economic Commission for Asia and Far East (ECAFE). Its membership consists of countries of the Asian region and other regions as well. Presently, there are 47 members out of which 32 countries are from the Asia-Pacific region while 15 countries are from Europe and North America.

Functions : The main objectives and functions of ADB are –

i) To promote investment in the ECAFE region of public and private capital for development purposes,

ii) To utilise the available resources for financing development, giving priority to those regional and sub-regional as well as national projects and programmes which will contribute most effectively to the harmonious economic growth of the region as a whole, and having special regard to the needs of the smaller or less developed member countries in the region,

iii) To meet the requests of members in the region to assist them in co-ordination of their development policies and plans so as to achieve better utilisations of their resources making their economies more complementary and promoting the orderly expansion of their foreign trade, in particular, intra regional trade,

iv) To provide technical assistance for preparation, financing and execution of development projects and programmes, including the formulation of specific proposals,

v) To co-operate with the United Nations, its organs and subsidiary bodies, in particular ECAFE and with public international organizations and other international institutions as well as national entities whether public or

private, and to interest such institutions and entities in new opportunities for investment and assistance, and

vi) To undertake such other activities and to provide such other services as may advance its purposes.

Organisational Structure : ADB's highest policy-making body is the Board of Governors. The Board of Governors consists of 12 Directors out of which 8 represents regional countries and 4 represent non-regional countries. The President of the Bank is elected by the Board of Governors and is also the Chairman of the Board of Governors.

Resources and Financial Assistance : The financial resources of the Bank consist of equity capital comprising of subscribed capital and reserves. Besides equity funds, ADB also has access to funds raised through borrowings and Special Funds comprising of contributions from member countries and amounts previously set aside from the paid-up capital.

ADB provides loans out of the equity funds generally to the member countries, which have attained a somewhat higher level of economic development. Loans from the Special Funds are disbursed exclusively to the poorest borrowing countries at highly concessional rates of interests.

Check Your Progress 1

1) What are SDRs? How are they created?

....

....

....

....

2) True/False :

a) ADB funds projects only in the Asian Region. (True/False)

b) IDA is also referred to as the "Soft Loan Window" (True/False)

c) IFC provides financial assistance to projects in the government sector. (True/False)

d) IMF depends entirely on its equity capital for it's lending operations. (True/False)

e) IMF assists its member to tide over their balance of payments problems. (True/False)

3) Explain the type of financial assistance provided by International Finance Corporation.

....

....

....

14.3 EUROPEAN MONETARY SYSTEM (EMS)

As a first step towards the economic unification of Europe, a treaty was signed in 1951, under which the European Coal and Steel Community (ECSC) was formed. In 1957, the Treaty of Rome was signed and the European Economic Community (EEC) came into existence. The main objective of the EEC was to facilitate an unfettered movement of goods, capital and manpower. As more countries joined, it was decided to establish a European Monetary System. Finally, with the signing of the Maastricht Treaty in 1992, the EEC was renamed as the European Union (EU) and the way was opened for setting up of institutions leading to the establishment of the European Monetary Union (EMU).

The objectives of European Monetary System : The primary objective of the EMS, is to provide and enhance monetary stability in the European Community. Its objectives include working towards the improvement in general and economic situation of the countries of the EU in terms of growth, full employment, standard of living, and reduction in regional disparities. It also aims at brining about a stabilising effect on international economic and monetary relations.

The key feature of the EMS is the Exchange-Rate Mechanism (ERM), which links the currencies to one another. EMS's long-term goal is monetary unification leading to a single currency called the European Currency Unit (ECU). The EMS is one of the facets towards the economic unification in Europe. Various steps have been taken to achieve this end. **As a first step**, border controls, which are used to enforce national quantitative restrictions that restrain imports from the rest of the world, have been abolished. The intention is to convert these restrictions into Community-wide restrictions. The **second step** is the elimination of technical barriers to trade by mutual recognition of most barriers and harmonisation of others such as health, safety, and environmental regulations. The principle of mutual recognition implies that products legally marketed in one Member State can circulate freely throughout the EC. The **third step** is the opening up of the public procurment in four areas not already covered by existing international trade agreements—telecommunications, transportations, energy and water supply.

European Currency Unit : The European Currency Unit (ECU) is central to the EMS. It is a basket of various currencies of the EU weighted according to the economic strength of each one of them. The quantities of each currency

in ECU stay the same while exchange rate fluctuate, as a result of these fluctuations, the values and, therefore, the weightage of the various currencies may change. However, reconstitution or revision of the basket of currencies takes place, usually after every five years.

The composition of the ECU as of June 1991 is given below:

Table 14.1 : Composition of the ECU (as of June 1991)

Currency	Fixed amount of Currency in the ECU	Weight (%)
Deutschmarks	0.6242	30.2
French franc	1.332	19.0
Pound sterling	0.08784	12.5
Dutch guilder	0.2198	9.5
Belgian franc	3.301	7.8
Spanish peseta	6.885	5.3
Danish kroner	0.1976	2.5
Irish pound	0.008552	1.1
Greek drachma	1.440	1.1
Portuguese escudo	1.393	0.8
Italian lira	151.8	9.9
Luxembourg franc	0.13	0.3

14.4 EURO MARKET

During the 1950s, the erstwhile USSR was earning dollars from the sale of gold and other commodities, which was to be used to purchase grains and other items from the West. USSR did not want to keep the sale proceeds in the US banks, as it feared that the US government might freeze the deposits, in case the cold war intensified. Hence, they approached banks in UK and France who accepted these dollar deposits and invested them partly in the US. Thus, originated the concept of **"Eurodollars"**.

A Eurodollar deposit is a deposit in the relevant currency with a bank outside the home country of that currency. Thus, a US dollar deposit with a bank in Paris is a Euro dollar deposit as is a Deutschmark deposit by a US company with the Geneva subsidiary of a US bank will still be called a Eurodollar deposit.

The real impetus in the growth of Euro dollar market came from the US itself in the form of Regulation Q of the Federal Reserve Act, which put a ceiling on the interest rates that

could be paid on bank deposits. Under the regulation, no interest was payable on bank deposits of less than 30 days' tenure, while interest rates for longer tenure were governed by strict ceilings. Thus, on one hand, the interest rates payable on dollar deposits in the US were restricted. On the other hand, there was no such restriction on deposits outside the US. The banks, outside the US, were able to attract substantial dollar funds by offering higher interest rates than prevailing in the US. Further Regulation M of the Federal Reserve Act, encouraged the flow of dollar deposits from the US. Under this regulation, banks were required to maintain certain percentage as reserves against the dollar deposits. This regulation was not applicable to the deposits held by the European branches of the US banks. This made the cost of funds of the US branches higher as compared to the outside branches, which were able to pass on their saving in lower funds cost to their customers. All these factors encouraged the flow of funds from the US to branches outside the US.

Euro-currency market is a highly competitive market with free access for new institutions in the market. Consequently, the margin between the rate of interest on the deposits and the advances has narrowed down considerably. The transactions in the market involve large sums of money, which has led to syndication of loans where a number of banks participate in a lending programme. A special feature of the Euro-currency market is the "floating rates of interest" under which the rates are linked to a base rate such as the London Inter-Bank Offered Rate (LIBOR). The interest rates on the deposits or advances are reviewed periodically in accordance with the LIBOR. The Euro currency market can broadly be divided into 4 segments as follows :

- Euro-credit market where the International banks lend funds on a long to medium-term basis,
- Euro-bond market where the banks raise funds on behalf of international borrowers,
- Euro-currency deposit/market where banks accept deposits usually on short-term basis, and
- Euro notes market where large corporations borrow funds.

14.5 INDIA AND FOREIGN CURRENCY FINANCE

Indian corporates regularly import capital equipments and critical raw materials. To make the payment for the same, they need foreign currencies. Indian industry has been largely dependent on the All-India Financial Institutions for their requirements of foreign currencies. These financial institutions provide foreign currency loans not only for

meeting the cost of plant and machinery, but also the foreign technical know-how fees as well.

These financial institutions, in turn, raise resources in the international financial markets and from multi-lateral financial institutions. Apart from the above, there are other sources of raising long/medium term foreign currency finance for Indian companies which are discussed below :

14.5.1 External Commercial Borrowings (ECBs)

The Government of India now permits Indian companies to raise finance for expansion of existing capacity and fresh investments through External Commercial Borrowings. As per the guidelines issued by the Government of India, companies are free to raise ECBs from any internationally recognised source such as banks, export credit agencies, suppliers of equipments, foreign collaborators, and international capital markets. The salient features of the ECB guidelines as revised from time to time are as follows :

i) **Average Maturity Period** : For ECBs less than USD 20 million equivalent, the minimum average maturity is three years. For ECBs of more than USD 20 million equivalent, the minimum average period is five years. However, 100% Export Oriented Units, are permitted to raise ECBs with minimum average maturity of three years for any amount.

ii) **Quantum of ECBs** : All infrastructure and Greenfield projects are permitted to raise ECBs to the extent of 35% of the total project cost. In case of power projects, more flexibility is allowed based on the merits of each case.

iii) **Rate of Interest** : ECBs can be raised at interest rate upto 1 or 2% points over LIBOR depending upon the credit worthiness of the borrower.

iv) **End-use of ECBs** : ECBs are to be utilised for meeting the foreign exchange costs of capital goods and services. In case of Infrastructure projects such as Power, Telecom, Roads, Ports, Industrial Parks and Urban Infrastructure, proceeds of ECBs can be used for meeting the project related rupee expenditure. ECBs by corporate borrowers can be used to acquire ships/vessels from Indian shipyards. However, under no circumstances, ECB proceeds can be utilised for investments in real estate and speculation in stock market.

v) **Security** : The choice of security to be given to the lender is to be decided by the borrower company. However, in case the security is in the form of guarantee from an Indian Financial Institution or Bank, no counter guarantee or confirmation of the guarantee by a Foreign Bank/Financial Institution is permitted.

The aim of the Government policy regarding External Commercial borrowings is to provide flexibility in borrowings by Indian Corporates and public sector undertakings. At the same time, a safe limit for total external borrowings consistent with provident debt management is to be maintained. The guiding principles for ECB policy are :

i) To keep maturities long,

ii) Low cost, and

iii) Encourage infrastructure and export sector financing.

Every year an ECB cap is fixed keeping in view the requirements of different sectors and medium-term balance of payment projections. The debt service ratio is kept within limit.

Approvals given for External Commercial Borrowing during the last 3 years have been as follows :

1998-99 : US $ million 5,200

1999-00 : US $ million 3,398

2000-01 : US $ million 2,837

Gross disbursement of external commercial borrowings (excluding funds raised through India Millennium Deposits of US $ 5.51 billions) amounted to US $ 3.81 billion in 2000-01. The increase over the previous year was mainly on account of re-financing of pre-payment of more expensive loans with relatively softer terms.

14.5.2 Euro-issues

Consequent to the economic liberalisation programme initiated since the 1990s, Indian corporates have been frequently accessing the international capital markets through the issue of bonds and euro-equities collectively called the "Euro-issues". There are principally two mechanisms— **Depository Receipts**, which represents the indirect equity investments and the **Euro-convertible Bonds**, which are debt instruments with an option to convert into equity.

In the Depository Receipts mechanism, the shares issued by the company are held by a depository, which in turn, issues claims against these shares. These claims are called the Depository Receipts. Each receipt has a claim on a specified number of shares. The underlying shares are called the depository shares. The depository receipts are denominated in a convertible currency, usually dollars and are generally listed and traded on major stock exchanges. The Issuer Company pays dividends to the depository in the home currency, which is converted into dollars by the

depository and distributed, to the depository receipt holders. Through the mechanism of the Depository receipts, the Issuer Company is able to avoid the payment of listing fees and also the disclosure and reporting requirements of the international stock exchanges. Such depository receipts when issued to investors in the US are called the American Depository Receipts (ADRs). However, there has been emergence of European Depository Receipts (EDRs) and the Global Depository Receipts (GDRs).

The Government of India permitted Indian Companies to issue GDR's in 1992 and issued guidelines as follows:

i) An Indian company planning to raise funds through the GDRs has first to obtain permission from the Foreign Investment Promotion Board (FIPB) Deptt. of Economic Affairs, Govt. of India.

ii) **End-use restriction** : GDR issues are permitted only for the following end-use to be incurred within one-year from the date of issue :

   a) Financing import of capital goods;

   b) Financing domestic purchase/installation of plant, equipment and building;

   c) Pre-payment or scheduled payment of earlier external borrowings;

   d) Making investments abroad where these have been approved by competent authorities;

   e) Equity investment in Joint Ventures and Wholly owned subsidiaries in India;

   f) Corporate restructuring, up to a maximum of 25% of the issues proceeds.

iii) **Eligibility** : Only companies having consistent track record of good performance (financial and otherwise) for a minimum period of three years are allowed to issue GDRs. However, in case of infrastructure projects, this condition is relaxed.

iv) Banks, Financial Institutions and Non-Banking Finance Companies (NBFCs) registered with RBI are exempted from the end-use restriction provided that they do not invest the proceeds of the issue in real-estate and stock markets.

v) All India Financial Institutions are also exempted from the end-use restrictions considering the multiplier effect and beneficial impact on the small-scale and medium industries since they cannot access these markets on their own.

vi) There is no restriction on the number of issues, which a company or a group of companies may float, in a financial year.

vii) The company shall be required to specify the proposed end uses of the issue proceeds at the time of making their application, and will be required to submit quarterly statement of utilisation of funds for the approved end-uses, duly certified by their auditors.

Check Your Progress 2

1) What do you understand by External Commercial Borrowings?

....

....

....

2) Name the various segments of Euro currency market.

....

....

....

3) Which companies are authorised to issue GDRs.

....

....

....

14.5.3 Foreign Direct Investments

Since the Government of India permitted the flow of foreign investments in India in 1992, there has been a rising trend in the inflow of such investments. Foreign investments fall in two broad categories : (1) Direct Investment and (2) Portfolio Investment.

Foreign Direct Investments may be held by a person resident outside India (except Bangladesh, Pakistan or Sri Lanka). It can be by way of equity preferences/convertible preferences shares and convertible debentures issued by an Indian Company within prescribed limits. According to the Government's policy direct foreign investments are permitted in certain sectors through automatic route (i.e. no permission is required). In some other sectors, there are sectoral limits prescribed. In the remaining cases, prior approval of Secretariat for Industrial Assistance (SIA) or of Foreign investment Promotion Board (FIPB) of the Government of India is required. The terms and conditions prescribed by these authorities are to be complied with. Foreign Investments are allowed upto 100% in certain deserving sectors, e.g. exports. As is evident from the Table 14.1 given

below investment through FIPB/SIA route accounted for the bulk of foreign direct investment during 2000-01.

14.5.4 Portfolio Investments

Under the Portfolio Investment Scheme, foreign institutional investors (FII) registered with Securities and Exchange Board of India are permitted by the Reserve Bank of India to purchase shares and convertible debentures of Indian companies through registered brokers at recognised Stock Exchanges in India. These institutions are permitted to invest in India within certain limits only, e.g. each FII can invest upto 10% of total paid up capital of the Indian company or 10% of the paid up value of each convertible debentures issues by an Indian company. Total holding of all FIIs together shall not exceed 24% of the paid up equity capital or paid up value of each series of convertible debentures. The aggregate limit of all FIIs, may be increased to 49% with the approval of the general body of shareholders. Purchase through private placement/arrangement is also permitted, subject to the above ceilings. Recently, FIIs have also been permitted portfolio investment through Secondary market up to the applicable sectoral levels of the issued and paid up capital of the company.

Portfolio investment is also permitted for Non-Resident Indians and Overseas Corporate Bodies on a recognised Stock Exchange in India on repatriation or non-repatriation basis, through a registered broker. But each NRI is permitted to hold such shares up to 5% of the paid up value of shares issued by the Indian Company/paid up value of each series of convertible debentures. Aggregate paid up value of shares of all NRIs/OCBs should not exceed 10% of the paid-up value of equity shares/each series of debentures. This limit may be raised to 24% by a special resolution at the General Body Meeting.

Table 14.2 : Foreign Direct Investment in India (US $ Million)

	1991-92	2000-01
A. Direct Investment	129	2339
(a) RBI Automatic route	--	454
(b) SIA/FIPB route	66	1456
(c) NRIs (40% & 100%)	63	67
(d) Acquisition of Shares *	–	362
B. Portfolio Investment	4	2760
(a) Foreign International Investor	--	1847
(b) GDRs/ADRs	--	831
(c) Offshore funds/others	4	82
Total A & B	**133**	**5099**

Source: Economic Survey 2000-01

* Related to acquisition of shares of Indian Companies by NRIs under section 5 of FEMA.

14.5.5 Non-Resident Indians' Deposits

Another source of foreign currency finance is the deposits made in Indian Banks by Non-Resident Indians. Reserve Bank of India has permitted the banks to open mainly three types of deposit accounts in the names of non-resident Indians. These accounts are held in Indian rupees as well as in four major foreign currencies. Under the Foreign Currency Non-Resident (Banks) scheme {FCNR (B)}, deposits are accepted in dollars, pounds, yen and Euro and they are repatriable in the foreign currency also. Under non-resident External Rupee Accounts (NRERA), accounts are accepted in rupee, which are repatriable in foreign currency but at the prevailing rate of exchange. Non-resident (Non-Repatriable) Rupee Deposits Scheme (NRNRRD) does not provide for repatriation of the deposits made in rupees. Table 14.3 shows the outstanding balances under these schemes in recent years.

Table 14.3 : Outstanding Balances under NRI Deposit Schemes (US $ million)

Scheme	March		
	1999	2000	2001
FCNR (B)	7835	8172	9076
NRERA	6045	6758	7147
NRN RRD	6618	6754	6849
Total	**20498**	**21684**	**23072**

Source : Economic Survey 2000-01

The above figures are inclusive of accrued interest also. The increasing trend of outstanding balances in these accounts shows the overall confidence of non-resident Indians in the strength of Indian economy.

Check Your Progress 3

1) Fill up in the blanks:

   i) Foreign investment can be put under .... categories.

   ii) Foreign investment is allowed to the extent of .... per cent in export sector.

   iii) Foreign institutional investors are allowed to invest in India upto .... of total paid-up capital of Indian company.

   iv) RBI has permitted banks to open .... types of account in the names of NRIs.

14.6 LET US SUM UP

The Financial System at the global level helps in the transfer of resources across countries. The need for such transfer of resources from one country to another may arise due to international trade in goods and services. The international monetary system, which operated just prior to 1914, was called the "Gold Standared System". Under this system, "gold and sterling" were the two assets, which were accepted in the settlement of international debt and were called the reserve assets. The post-war monetary system was created in 1944 at the Bretton Woods, New Hampshire, USA, where a conference was organised by the representative of the Allied countries to find out a way for an orderly conduct of international trade promote good monetary system. A new institution called the International Monetary Fund (IMF) was set-up to promote consultation and collaboration on international monetary problems and to lend to its member countries in need due to persistent deficit in the balance of payments.

The International Monetary Fund (IMF) is the central institution of the international monetary system as it facilitates the adjustment of balance of payment imbalances. International Bank for Reconstruction and Development (IBRD) or the World Bank provides long-term financial assistance to its member countries for their reconstruction and development. The International Finance Corporation (IFC) is an affiliate of the World Bank which provides equity funds to the private enterprises. International Development Association (IDA) is another affiliate of the World Bank and also referred to as the "soft loan window" of the World Bank as it provides "soft loans" for economically sound projects of social importance to the member countries. Asian Development Bank (ADB) promotes investment in the ECAFE region of public and private capital for development purposes.

The main objective of the EEC was to facilitate an unfettered movement of goods, capital and manpower. As more countries joined, it was decided to establish a European Monetary System. Finally, with the signing of the Maastricht Treaty in 1992, the EEC was renamed as the European Union (EU) and the way was opened for setting up of institutions leading to the establishment of the European Monetary Union (EMU). The primary objective of the EMU is to provide and enhance monetary stability in the European Community. The European Currency Unit (EC) is a basket of various currencies of the EU weighted according to the economic strength of each one of them. A Eurodollar deposit is a deposit in the relevant currency with a bank outside the home country of that currency.

Indian corporates have been largely dependent on the All-

India Financial Institutions for their requirements of foreign currency. Other major sources of raising long/medium-term foreign currency funding for Indian companies are External Commercial Borrowings and Euro Issues.

14.7 KEY WORDS

Eurodollar Deposit is a deposit in the relevant currency with a bank outside the home country of that currency.

Quota is the contribution of the member countries towards the equity capital of the IMF to be originally contributed in the form of gold and the country's own currency. The size of the quota was to be a function of each member's size to the world economy.

Special Drawing Rights (SDRs) is the international reserve asset, which was originally equivalent to a fixed number of dollars. Now, it is a basket of various currencies such as US dollars, German Deutschmarks, Japanese Yen, French Francs and British pound sterling.

Tranches is the process of drawings the SDRs by a member country from the IMF.

14.8 SOME USEFUL BOOKS

Adrian Buckly (1998): *Multinational Finance*, Third Edition, Prentice-Hall of India Private Limited, New Delhi.

Apte P. G. (1998): *International Finance*, Third Edition, Prentice-Hall of India Private Limited, New Delhi.

Giddy Ian H. (1997): *Global Financial Markets*, AITBS Publishers & Distributors, New Delhi

14.9 ANSWERS/HINTS TO CHECK YOUR PROGRESS

Check Your Progress 1

1) Special Drawing Right is a basket of various currencies (US $, German Deutschmarks, Japanese Yen, French Francs and British Pond sterling which is equivalent to a fixed number of dollars. It is an instrument of IMF for creation of a new international reserve asset.

2) (a) False (b) True (c) False (d) False (e) True

3) Direct lending, equity investment, providing developmental services.

Check Your Progress 2

1) External Commercial Borrowings refers to raising of long/medium-term foreign currency finance from any internationally recognised source such as banks, export credit agencies, foreign collaborators etc.

2) Euro credit market, Euro bond market, Euro currency deposit/market, Euro notes market.

3) The companies having consistent track record of good performance for a minimum period of 3 years.

Check Your Progress 3

1) (i) two (ii) 100 per cent (iii) 3-10 per cent (iv) three